Loyola of Los Angeles Law Review

Law Reviews

4-1-2014

Taxing Reality: Rethinking Partnership Distributions

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TAXING REALITY: RETHINKING PARTNERSHIP DISTRIBUTIONS

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Partnerships play an increasingly vital role in the federal income tax. Yet partnership taxation is deeply flawed, with complicated provisions that strain the voluntary compliance mechanism on which all federal income tax relies. This Article considers one of the most difficult challenges facing partnership taxation: the treatment of distributions.

Distributions are ubiquitous transactions that transfer cash or property from a partnership to a partner. Although distributions vary dramatically in their purpose and the kind of property involved, their tax treatment follows a unitary approach. The principle of "nonrecognition" means that distributions do not produce any immediate tax consequences. This nonrecognition premise has caused great abuse and complexity, as partnerships have used distributions as tax shelter vehicles, and the government has responded with narrow anti-abuse "fixes" that are often counterproductive. Calls to reform these anti-abuse provisions have been a constant presence throughout a half-century of tax scholarship.

This Article argues that the existing scholarship largely misconstrues the problem with partnership distributions. The core difficulty is the nonrecognition premise at the system's foundation, the very problem that particular anti-abuse provisions were designed to combat. Meaningful reform of partnership distributions thus requires a fundamental rethinking of nonrecognition and its role in partnership taxation.

This Article offers an alternative vision of partnership distributions, one without the imprint of nonrecognition. It reimagines partnership distributions from a recognition-based perspective, which would ground the tax treatment of these transactions in economic reality. Of particular importance are liquidating distributions that involve the complete or partial termination of a partner's investment in the partnership. Consistent with their commercial substance,

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liquidating distributions should be treated as taxable exchanges in which the partner receives cash or property from the partnership in exchange for relinquishing her interest in the partnership and its underlying property. Under a recognition-based approach, partnership distributions would indeed look very different than they do today, simpler, more equitable, and more stable.

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I. INTRODUCTION

The federal income tax is undeniably complicated, too complicated for most taxpayers. A recent study by the Office of the Taxpayer Advocate found that "it takes U.S. taxpayers (both individuals and businesses) more than 6.1 billion hours to complete filings required by a tax code that contains almost four million words and that, on average, has more than one new provision added to it daily."[1] Despite these efforts, many taxpayers cannot get it right, as they find themselves unable to understand or apply the tax law. Other taxpayers find opportunity in this complexity, using it to blur the line between proper planning and improper abuse.

These dynamics are even more troublesome in partnership taxation, which plays an increasingly vital role in the federal income tax system.[2] In recent years, partnerships and other non-corporate entities have earned more than half of the business income reported to the federal government.[3] During this same period, the number of partnerships increased sharply, and more businesses today operate as partnerships than as corporations.[4]

Yet the legal complexities of partnership taxation present unique challenges. Subchapter K, which contains the provisions governing the taxation of partnerships and their partners, is distinctively grounded in a commitment to taxpayer flexibility. Its rules are

1. 1 NAT'L TAXPAYER ADVOC., 2012 ANN. REP. TO CONGRESS (2012), *available at* www.taxpayeradvocate.irs.gov/userfiles/file/Full-Report/Volume-1.pdf [hereinafter 2012 NTA Report].

2. In this Article, the term "partnership" is used to refer to any entity, including a limited liability company, electing to be treated as a partnership for federal income tax purposes. Treas. Reg. §§ 301.7701-1 (as amended in 2009), -2 (as amended in 2009), -3 (as amended in 2006).

3. *See* THE PRESIDENT'S ECON. RECOVERY ADVISORY BD., THE REPORT ON TAX REFORM OPTIONS: SIMPLIFICATION, COMPLIANCE, AND CORPORATE TAXATION 74–75 (2010), *available at* http://www.whitehouse.gov/sites/default/files/microsites/PERAB_Tax_Reform_Report.pdf; MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R42359, WHO EARNS PASS-THROUGH BUSINESS INCOME? AN ANALYSIS OF INDIVIDUAL TAX RETURN DATA 1 n.1 (2012), *available at* www.fas.org/sgp/crs/misc/R42359.pdf; Pamela F. Olson, *And Then Cnut Told Reagan . . .*, 131 TAX NOTES 993, 995 (2011).

4. *See* 2012 NTA Report, *supra* note 1, at 21 (noting that in 2011, 3.6 million partnership tax returns were filed, as compared to the 2.3 million C corporations that filed returns); INTERNAL REVENUE SERV., 2011 DATA BOOK 4–5 tbl.2, *available at* http://www.irs.gov/pub/irs-soi/11databk.pdf. Additionally, the number of partnerships grew at an average annual rate of 4.7 percent from 2001 to 2010. *See* Nina Shumofsky et al., *Partnership Returns, 2010*, 32 STAT. OF INCOME BULL., Fall 2012, at 79.

generally designed to maximize a partnership's ability to structure its affairs in whatever manner the partners consider commercially optimal.[5] This flexibility, however, has come at a steep price in the form of tax abuse and complexity. Partnerships have become the preferred vehicle for tax shelter transactions due largely to subchapter K's permissive rules; and subchapter K, in turn, has become crowded with a complicated patchwork of provisions designed to combat these abusive transactions.[6] A vicious cycle has thus emerged in partnership taxation: flexibility leads to abuse, such abuse triggers governmental responses that are typically complicated and rarely complete, and these responses inspire the next generation of tax shelter transactions. This cycle continues today at significant public cost, compromising partner compliance, government revenues, and subchapter K's public legitimacy.

This Article will consider one of subchapter K's most difficult problems—the treatment of partnership distributions.[7] Distributions are ubiquitous transactions involving the transfer of cash or property from a partnership to a partner. Distributions vary dramatically based on their purpose, the type of assets involved, and their legal effect, but their tax treatment largely follows a unitary approach. Consistent

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5. *See* H.R. REP. NO. 83-1337, at 65 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4017, 4091; S. REP. NO. 83-1622, at 89 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4721; *see also* Mark P. Gergen, *Reforming Subchapter K: Special Allocations*, 46 TAX L. REV. 1, 1 (1999); Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1078 (2006); Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815, 821 (1992); Lawrence Lokken, *Taxation of Private Business Firms: Imagining a Future Without Subchapter K*, 4 FLA. TAX REV. 249, 254 (1999); George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 154 (1999).

6. This Article adopts the following definition of a tax shelter: an abusive transaction "is a transaction which is designed to technically comply with the letter of the law, but which produces tax savings that are inappropriate to the underlying purposes of the statutory scheme and inconsistent with the economic reality of the transaction." Noël B. Cunningham & James R. Repetti, *Textualism and Tax Shelters*, 24 VA. TAX REV. 1, 20 (2004); Alan Gunn, *The Use and Misuse of Antiabuse Rules: Lessons from the Partnership Antiabuse Regulations*, 54 SMU L. REV. 159, 164 (2001).

7. One might wonder why partnership distributions have received so little attention throughout the years. Professor William Andrews proposed the following answer: "Likely reasons in fact why distributions have not been a matter of legislative attention in their own right are (1) the relative complexity of the problems presented by distributions (of which persistent readers will soon have ample experience), and (2) the tendency to analyze, teach and study partnership problems chronologically over the life of a hypothetical partnership, so that contributions come relatively early while distributions are only reached relatively late when analyst, teacher and student are all exhausted." William D. Andrews, *Inside Basis Adjustments and Hot Asset Exchanges in Partnership Distributions*, 47 TAX L. REV. 3, 7 n.20 (1991).

with subchapter K's commitment to flexibility, distributions are generally treated as "nonrecognition" events.[8] That is, distributions do not trigger any immediate tax consequences for the partnership or the distributee partner. This policy has led to great abuse, with partnerships often using distributions as tax shelter vehicles. In the past half-century, Congress and the Department of the Treasury ("Treasury") have responded to abusive distributions with complicated "fixes," each working to prevent particular abuses without infringing on legitimate partnership transactions.

The section 751(b) disproportionate distribution rule is the most important of these fixes, standing as the primary bulwark against abusive distributions.[9] It is also one of subchapter K's most highly criticized provisions. Section 751(b)'s complexity is matchless, as it involves a seven-step computational process that includes three fictional transactions between the distributee partner and the partnership.[10] Even so, the provision fails to prevent many of the abuses that it was designed to eliminate. Calls for reforming or repealing section 751(b) have thus continued from the provision's codification in 1954 to the present.[11]

This Article argues that section 751(b)'s critics have misconstrued the problem. Section 751(b) is not the problem with

8. I.R.C. § 731(a)–(b) (2006).

9. Andrews, *supra* note 7, at 4.

10. WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 21.03 (4th ed. 2007).

11. *See, e.g.*, AM. LAW INST., FEDERAL INCOME TAX PROJECT—TAXATION OF PRIVATE BUSINESS ENTERPRISES: MEMORANDUM NO. 3 65–77 (1997) [hereinafter AM. LAW INST., MEMORANDUM NO. 3]; AM. LAW INST., FEDERAL INCOME TAX PROJECT—SUBCHAPTER K: PROPOSALS ON THE TAXATION OF PARTNERS 51–55 (1984) [hereinafter AM. LAW INST., SUBCHAPTER K PROJECT]; AM. BAR ASS'N SECTION OF TAXATION, TAX SECTION RECOMMENDATION NO. 1974–11, *reprinted in Committee on Partnerships*, 27 TAX LAW. 839, 842, 876 (1974); STAFF OF THE JOINT COMM. ON INTERNAL REVENUE TAXATION, 86TH CONG., SUMMARY OF THE SUBCHAPTER K ADVISORY GROUP RECOMMENDATIONS ON PARTNERS AND PARTNERSHIPS 40 (1959); Andrews, *supra* note 7, at 52–55; Curtis J. Berger, *W(h)ither Partnership Taxation?*, 47 TAX L. REV. 105, 148 (1991); Karen C. Burke, *Partnership Distributions: Options for Reform*, 3 FLA. TAX REV. 677, 713–17 (1998); James S. Eustice, *Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm (Some Preliminary Proposals)*, 39 TAX L. REV. 345, 381–85 (1984); Mark P. Gergen, *Reforming Subchapter K: Contributions and Distributions*, 47 TAX L. REV. 173, 200 (1991); Christopher H. Hanna, *Partnership Distributions: Whatever Happened to Nonrecognition?*, 82 KY. L. REV. 465, 469–85 (1994); Philip F. Postlewaite et al., *A Critique of the ALI's Federal Income Tax Project – Subchapter K: Proposals on the Taxation of Partners*, 75 GEO. L.J. 423, 596–611 (1986); E. George Rudolph, *Collapsible Partnerships and Optional Basis Adjustments*, 28 TAX L. REV. 211, 217 (1957); Yin, *supra* note 5, at 233–38.

partnership distributions, despite its many technical and structural flaws. The problem with partnership distributions is the nonrecognition premise at the system's foundation, the very problem that section 751(b) was designed to fix. Reforming section 751(b) is therefore not the answer. Meaningful reform of partnership distributions requires a foundational rethinking of the role of nonrecognition in subchapter K. A first step in this process is to rationalize the tax treatment of partnership distributions, aligning it with the economic reality of these transactions. In doing so, partnership distributions would become simpler and less prone to abuse. Indeed, reconceptualizing distributions would promote stability in subchapter K, grounding our thinking about this crucial transaction in coherent principles.

This Article proceeds in two parts. Part II begins with an introduction to distributions, their persistent challenges, and their unique position in subchapter K. It maps the dysfunctionality of modern distributions, tracing the system's flaws to the foundational premise at its core—nonrecognition. Part III proposes an alternative vision of partnership distributions designed to promote simplicity, equity, and stability in subchapter K. This approach first divides distributions into two categories: operating distributions and liquidating distributions. It then turns to the tax treatment of each category, proposing rules that correspond to the commercial substance of the underlying distribution transaction. This Article's primary reforms relate to liquidating distributions, which typically involve the partial or complete termination of a partner's investment in a partnership. Under this proposal, these distributions would be taxable, viewed as transactions where a partner relinquishes her partnership interest and, in exchange, receives cash or property from the partnership.

II. THE PROBLEM OF PARTNERSHIP DISTRIBUTIONS

The story of partnership distributions is much like the larger story of subchapter K. It begins with a system designed to maximize partnership freedom and ends with a system that is complex, inequitable, and utterly dysfunctional. This part traces the evolution of partnership distributions from the vantage of the system's foundational nonrecognition premise, analyzing the role of nonrecognition in the discord surrounding these transactions.

A. Nonrecognition-Based Partnership Distributions

When Congress codified subchapter K in 1954, it hoped to create a system of taxation that was flexible, simple, and fair.[12] Subchapter K's original provisions prioritized flexibility, allowing partnerships to structure their affairs in whatever manner they considered commercially optimal.[13] Simplicity was also important, as Congress wanted subchapter K to be accessible to all partnerships regardless of their sophistication level.[14] Equity, in contrast, was largely viewed as an intrapartnership matter. Congress wanted partners' relative tax burdens to be fair in light of their relative circumstances, but it largely considered the revenue stakes in subchapter K insufficiently high to warrant government intervention.[15] In the few instances where abusive transactions posed a revenue threat to the federal government, however, Congress adopted affirmative anti-abuse provisions, thus fortifying subchapter K's ability to treat partners fairly based on their relative economic position.

The original provisions governing partnership distributions follow this model. Subchapter K's commitment to flexibility is reflected in the system's foundational nonrecognition premise.[16] Likewise, these provisions took a largely laissez-faire approach to equity, only focusing on abuse prevention in one particular situation. Simplicity, in contrast, was a different matter. As this part will demonstrate, partnership distributions, and subchapter K more generally, have never been simple.

1. The Basics of Subchapter K

As a starting point, a brief introduction to partnership taxation may prove useful. Subchapter K is a pass-through system of taxation.

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12. *See* H.R. REP. NO. 83-1337, at 65 (1954); S. REP. NO. 83-1622, at 89 (1954).

13. H.R. REP. NO. 83-1337, at 65; S. REP. NO. 83-1622, at 89.

14. H.R. REP. NO. 83-1337, at 65; S. REP. NO. 83-1622, at 89.

15. H.R. REP. NO. 83-1337, at 65; S. REP. NO. 83-1622, at 89. In the federal income tax context, equity is best explored through two components: horizontal equity and vertical equity. Horizontal equity requires that similarly situated taxpayers be taxed in the same manner. *See, e.g.*, JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 30 (1985); Brian Galle, *Tax Fairness*, 65 WASH. & LEE L. REV. 1323, 1325 (2008); Xuan-Thao Nguyen & Jeffrey A. Maine, *Equity and Efficiency in Intellectual Property Taxation*, 76 BROOK. L. REV. 1, 3 (2010). Vertical equity, in contrast, requires that partners with greater income be taxed more than those with less income. *See, e.g.*, WITTE, *supra* at 30.

16. I.R.C. § 731(a)–(b) (2006).

Unlike a corporation where income is taxed to the entity and again to its shareholders, a partnership's income is only subject to one level of tax. A partnership is not considered a taxpayer; instead, its partners pay tax on their shares of the partnership's annual income.[17] Subchapter K thus performs an allocative function, dividing the partnership's income among its partners.[18]

This unique pass-through role raises a foundational question of how to think of the partnership itself for federal income tax purposes. In many respects, a partnership can be thought of as an aggregate of its owners. Under this aggregate theory, a partnership is effectively disregarded, with its partners treated as direct co-owners of each item of the partnership's property. Yet in other respects, a partnership can be thought of as an entity separate and distinct from its owners. Under this entity theory, partners are treated like shareholders in a corporation, owning interests in the partnership entity itself, rather than interests in the partnership's underlying property.

Instead of adopting a uniform theory of partnerships, subchapter K follows both approaches, with different provisions reflecting different theories. On one hand, numerous computational and administrative provisions reflect the entity theory. For instance, a partnership computes its own taxable income and determines the character of any recognized gains or losses.[19] On the other hand, subchapter K's pass-through model embodies the aggregate theory, taxing partners directly on their share of a partnership's income.[20] Because the aggregate theory animates subchapter K's distinctive pass-through feature, the theory's view of partners as direct co-owners of partnership property serves as a useful touchstone when working through foundational issues in partnership taxation, such as the treatment of distributions.

This pass-through function also highlights the deep tensions in subchapter K. To illustrate, imagine that *A*, *B*, and *C* form a partnership to sell goods to the public, and each partner holds an equal one-third interest in the partnership. *C* signs a major account

17. *Id.* § 701. Indeed, the partners are taxable annually on their share of the partnership's income without regard to whether the corresponding funds are distributed to them during the relevant year.

18. *Id.* § 704(b).

19. *Id.* §§ 702(b), 703(a).

20. *Id.* § 701.

and, hence, she is responsible for virtually all of the partnership's income during the current year. In light of this development, the partners might decide to amend their partnership agreement, requiring the partnership to allocate taxable income among the partners based on their relative sales. But the partners might also decide against this approach, instead retaining their equal allocation arrangement. Notwithstanding *C*'s disproportionate share of the partnership's sales, subchapter K would permit the partnership to allocate its taxable income in this manner, one-third to each partner.[21]

In doing so, subchapter K challenges one of the most foundational premises of the federal income tax—that a transaction's tax consequences should match its economic consequences. Income is generally taxed to the person who performs the services or owns the property that produces that income.[22] Yet a partnership seems to change this equation, allowing the partners to shift tax liability among themselves. Indeed, subchapter K allows partners to achieve tax results that they could not achieve in their individual capacities, and this freedom is largely responsible for both the popularity and the problems of partnership taxation.

If left unchecked, this type of flexibility creates opportunities for partners to reduce their aggregate tax liability, sometimes at great public cost. Returning to the *ABC* partnership, consider the consequences if *C* were allocated one-third of the partnership's taxable income but allocated an amount of its economic gain corresponding to her share of the partnership's sales.[23] *C* would

21. *See* Schneer v. Comm'r, 97 T.C. 643, 658 (1991) ("If partners were not able to share profits in an amount disproportionate to the ratio in which they earned the underlying income, the partnership provisions of the Code would, to some extent, be rendered unnecessary.").

22. *See* Helvering v. Horst, 311 U.S. 112, 118 (1940) ("The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment, and hence the realization, of the income by him who exercises it."); Lucas v. Earl, 281 U.S. 111, 114–15 (1930) ("There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however 'skillfully' devised to prevent the salary when paid from vesting even for a second in the man who earned it. That *see*ms to us the import of the statute before us . . . .").

23. Operationally, these allocations are implemented through accounts that track a partner's economic and tax investments in the partnership. A partner's economic investment in a partnership is measured by her "capital account." Treas. Reg. § 1.704-1(b)(2)(iv). In general terms, the partner's capital account balance equals the amount that the partner is entitled to receive on liquidation of her partnership interest. *Id.* § 1.704-1(b)(2)(ii)(b)(2). A partner's tax investment, in contrast, is measured by her basis in her partnership interest, referred to as "outside

receive the economic benefit of almost all of the partnership's income, thereby entitling her to receive these funds on the liquidation of her partnership interest.[24] But *C* would not bear the corresponding tax liability for much of this income; her partners, *A* and *B*, would. Put another way, *A* and *B* would bear the tax liability corresponding to funds earmarked for *C*.

One might wonder why *A* and *B* would agree to this arrangement. The answer often lies in the partners' individual tax rates: if *C*'s marginal tax rate were higher than her partners, then shifting the partnership's taxable income from her to *A* and *B* would benefit the partnership, reducing the average tax rate applied to its income.[25] The partnership would thus win, with the income shift producing a net tax savings for its partners. The federal government, in contrast, would lose, deprived of the tax revenues necessary to finance its operations.

Because of these revenue concerns, Congress's commitment to flexibility in partnership taxation could not be limitless. At some point, Congress had to intervene, drawing a line between permissible partnership transactions and impermissible tax sheltering. These congressional efforts have taken many forms throughout the years, but all have been grounded in the premise that the tax and economic consequences of a transaction should match.[26] A partner's economic

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basis," which represents the amount of the partner's investment in the partnership that has previously been subject to tax. I.R.C. § 705.

24. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2).

25. To illustrate, let's assume that the *ABC* partnership has $3,000 of taxable income in the current year. *C* is responsible for generating 80 percent of the underlying sales, and *A* and *B* are each responsible for generating 10 percent of the partnership's sales. Let's further assume that *A*'s and *B*'s individual income tax rate is 0 percent, and *C*'s individual income tax rate is 39.6 percent. If the partnership allocated its taxable income in proportion to each partner's sales, *C* would be allocated $2,400 of taxable income ($3,000 total taxable income * 0.8 allocation ratio), and her resulting tax liability would be $950 ($2,400 allocated taxable income * 0.396 tax rate). *A* and *B* would each be allocated $300 of taxable income ($3,000 total taxable income * 0.1 allocation ratio), but neither partner would incur a tax liability. Taken together, the partners would pay taxes of $950 on taxable income of $3,000.

If, in contrast, the partnership allocated its taxable income equally among the partners, the partners' aggregate tax liability would decrease because less taxable income would be subject to tax at *C*'s 39.6 percent individual income tax rate. The partnership would now allocate $1,000 of taxable income to *C*, and her resulting tax liability would be $396 ($1,000 allocated taxable income * 0.396 tax rate). Likewise, the partnership would allocate $1,000 of taxable income to both *A* and *B*, and neither partner would incur a tax liability. Accordingly, the aggregate tax liability of the partners would now be $396, resulting in a net tax savings of $554.

26. *See, e.g.*, I.R.C. § 704(b). The provisions governing partnership allocations provide a useful example of this premise. As originally enacted, these provisions allowed partnerships great

investment in a partnership thus functions as a benchmark in subchapter K: if a partner receives an economic benefit from a partnership, she should also bear the corresponding tax burden.[27]

Returning to the *ABC* partnership, one can see how subchapter K implements this premise. If the partners wish to share the partnership's tax burden equally, then they must also share its economic benefits equally.[28] The partnership may thus allocate one-third of its taxable income to *C*, even though she is responsible for a larger percentage of the partnership's sales. This allocation, however, would only be permissible if the partnership were to allocate *C* one-third of the corresponding economic income. In doing so, *C* would reduce her tax liability, but at a steep price—a diminished share of the related economic benefit. Considered in this light, *C*'s acquiescence in this arrangement would likely stem from legitimate commercial considerations; perhaps each partner's share of annual sales is unpredictable, fluctuating dramatically from one year to the next. Linking the tax and economic consequences of a transaction in this manner thus serves a signaling function, highlighting that commercial considerations, rather than tax sheltering, animated the partners' arrangement.[29]

This tension between flexibility and equity runs throughout subchapter K, shaping the rules governing every event in a partnership's life. Flexibility is subchapter K's priority, and partnerships have great latitude in structuring transactions. Yet equity is also important, guiding much of our foundational thinking

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freedom in allocating their taxable items so long as the resulting allocations did not have a principal purpose of tax avoidance or evasion. *Id.* § 704(b) (1954). This standards-based approach to partnership allocations proved problematic, and Congress ultimately amended subchapter K, adopting the substantial economic effect safe harbor. *Id.* § 704(b) (1976). Under this approach, the partnership's contractual allocations will be respected to the extent they have substantial economic effect. *Id.*

27. I.R.C. § 704(b) (1976); Treas. Reg. § 1.704-1(b)(2).

28. Treas. Reg. § 1.704-1(b)(2)(ii)(a). This "economic effect" requirement provides that a partner's capital account, which reflects her economic investment in the partnership, and a partner's outside basis, which reflects her tax investment in the partnership, should move in unison: if a partnership allocates one dollar of economic income to a partner, as reflected in an increase to her capital account, then it should similarly allocate one dollar of taxable income to her, as reflected in an increase to her basis in her partnership interest. *Id.*

29. *See, e.g.*, GEORGE K. YIN & DAVID J. SHAKOW, AM. LAW INST., FEDERAL INCOME TAX PROJECT: TAXATION OF PRIVATE BUSINESS ENTERPRISES: REPORTERS' STUDY (1999); Emily Cauble, *Was Blackstone's Initial Public Offering Too Good to be True?: A Case Study in Closing Loopholes in the Partnership Tax Allocation Rules*, 14 FLA. TAX REV. 153, 171 (2013); Lokken, *supra* note 5, at 254; Yin, *supra* note 5, at 157.

about how partnerships should operate. Nonetheless, Congress's commitment to equity was not always reflected in subchapter K's provisions. Indeed, Congress considered equity an intrapartnership matter to be resolved by the partners themselves, only intervening in those rare instances where partnership inequities jeopardized federal revenues.

Considered in this light, equity's secondary role in subchapter K's original provisions is best viewed as a congressional miscalculation. Congress underestimated the revenue cost of abusive partnership transactions, like the income shifting discussed in the preceding example.[30] As a result, it left partnerships largely alone, unencumbered by equity-based restrictions on their freedom. It is through this lens that we now turn to subchapter K's greatest transactional challenge—partnership distributions.

2. The Basics of Partnership Distributions

Distributions are ubiquitous in the partnership world, involving the transfer of cash or property from a partnership to a partner.[31] Distributions, however, are not homogenous transactions; partnerships make distributions for numerous reasons, and their impact on a partnership and its partners varies accordingly.

To illustrate, consider again the *ABC* partnership. During the partnership's life, one could envision various events that would give rise to a distribution. For instance, the partnership might distribute a portion of its annual profits to the partners through a ratable cash distribution. In this scenario, the distribution represents income previously allocated and taxed to each partner.[32] Accordingly, this distribution itself would not change anything among the partners; before and after the distribution, each partner would have a one-third interest in the partnership. I will refer to this type of distribution as an "operating distribution."

30. *See, e.g.*, Gergen, *supra* note 5, at 1; Mark P. Gergen, *The End of the Revolution in Partnership Tax?*, 56 SMU L. REV. 343, 348 (2003); Lokken, *supra* note 5, at 250; Andrea R. Monroe, *Integrity in Taxation: Rethinking Partnership Taxation*, 64 ALA. L. REV. 289, 307 (2012).

31. In certain instances, liabilities also trigger subchapter K's distribution provisions. If a partner's share of the partnership's liabilities decreases, such decrease is treated as a deemed cash distribution. I.R.C. § 752(b) (2006).

32. *See infra* notes 39–42 and accompanying text.

In contrast, *C* might wish to retire from the partnership, collecting her share of the partnership's value and terminating her investment in the enterprise. In this instance, the partnership would make a distribution to *C*, and she would relinquish her partnership interest. This is an example of a "complete liquidating distribution." It effects a commercially significant change in the partnership, with *C* liquidating her entire investment. In doing so, the two remaining partners are left as equal stakeholders in a reconstituted *AB* partnership. Indeed, it is almost as if the distribution created a new partnership.

Between these extremes, various other kinds of distributions might occur, each marking an economic change in the partnership. For example, *C* may require a large sum of money to finance her son's law school education. To this end, *C* might propose that she relinquish a portion of her partnership interest in exchange for a distribution. After the transaction, *C* would thus remain a partner, but her partnership interest would be reduced. Like a complete liquidating distribution, this "partially liquidating distribution" affects the economics of the partnership. Indeed, the distribution reconstitutes the *ABC* partnership, with *C* holding a reduced partnership interest and *A* and *B* each holding a proportionately increased partnership interest.

Despite their diversity, subchapter K largely treats these distributions the same.[33] Its basic provisions prioritize flexibility, implementing this congressional commitment through a nonrecognition rule. When a taxpayer disposes of property, the transaction ordinarily triggers the taxation of any appreciation

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33. In certain instances, subchapter K divides distributions into two categories: liquidating distributions and current distributions. To that end, a "liquidation of a partner's interest" in a partnership is defined as the termination of a partner's entire interest in a partnership through one or a series of distributions. I.R.C. § 761(d). All other distributions, including partially liquidating distributions, are treated as current distributions. Treas. Reg. §§ 1.731-1(a)(1)(i), 1.761–1(d). In most instances, the separate provisions governing liquidating distributions are dictated by necessity, reflecting the fact that the retiring partner does not possess an interest in the partnership following the distribution. *See* I.R.C. §§ 731(a)(2) (losses recognized in certain complete liquidating distributions), 732(b) (basis of property distributed in a complete liquidating distribution). Section 736, which treats certain payments to a retiring partner as a distributive share of partnership income or a guaranteed payment, is the exception. *Id.* § 736. It is a more substantive partnership provision, but it only applies in limited circumstances. *Id.*; Philip F. Postlewaite & Adam H. Rosenzweig, *Anachronisms in Subchapter K of the Internal Revenue Code: Is It Time to Part with Section 736?*, 100 NW. U. L. REV. 379 (2006).

reflected in the property.[34] The amount of this taxable gain is equal to the difference between the property's fair market value and its basis, which represents the taxpayer's tax investment in the property at the time of disposition.[35] In certain instances, however, Congress made the affirmative decision that current taxation would be inappropriate and instead deferred recognition of this appreciation until the future.[36] I will refer to this unrecognized tax appreciation as "built-in gain."

Partnership distributions are one such instance. Neither the partnership nor the distributee partner recognizes gain on a distribution.[37] Rather, these transactions are designed to be invisible, with no immediate tax consequences. Any built-in gain in the distributee partner's partnership interest is thus deferred for future recognition when a more appropriate taxable event occurs.

To illustrate, consider again the *ABC* partnership. Imagine that each partner contributed $100 of cash to the partnership at formation, and it used $10 of these funds to purchase investment property ("Redacre"). The partnership is successful, generating income of $210 in its first year of operations. The partners share this income equally, $70 each, and properly report such amounts on their respective federal income tax returns.[38] Because the partnership is growing, it decides against making any corresponding cash distributions to the partners during this period. Accordingly, the partnership has the following balance sheet:

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34. I.R.C. § 1001. For ease of reading, this Article discusses appreciated property and the recognition of gains only. Even so, the following discussion applies equally to depreciated property and the recognition of losses. Unless specifically provided otherwise, the reader may thus assume that all references to gains, built-in gains, and appreciation also encompass their loss equivalents.

35. *Id.* § 1001(a).

36. For a more detailed discussion of when nonrecognition is considered appropriate, *see infra* notes 112–14 and accompanying text.

37. I.R.C. § 731(a) (nonrecognition for distributee partner), (b) (nonrecognition for partnership). In contrast, distributions are treated as recognition events from an economic, or book, perspective. Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1). As will be discussed, the capital account treatment of distributions is thus different from the corresponding tax treatment. For a more detailed discussion of the capital account treatment of partnership distributions, see *infra* notes 41 and 45.

38. I.R.C. § 704(b). As a result of this income allocation, each partner would increase her outside basis by $70, from $100 to $170. *Id.* § 705(a)(1)(A). Similarly, each partner would increase her capital account by $70 to reflect the corresponding allocation of economic income. Treas. Reg. § 1.704-1(b)(2)(iv)(b)(3).

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Cash	500	500	A	170	200
Redacre	10	100	B	170	200
			C	170	200
Total	510	600		510	600

If the partnership distributes $10 of cash to each partner several years later, subchapter K would treat the transaction as a nonrecognition event, and no partner would recognize gain on the distribution.[39] Any built-in gain in their respective partnership interests would instead be deferred for future taxation.

The mechanism subchapter K uses to achieve this deferral is basis. A partner's basis in her partnership interest, which I will refer to as "outside basis," must be adjusted following a distribution to preserve the proper amount of built-in gain in her partnership interest.[40] Put another way, retaining a continuous relationship between value and basis is necessary to ensure that any pre-distribution built-in gain is taxed when the underlying property is subsequently sold. Accordingly, a partner must reduce her outside basis by the amount of cash received in a distribution in order to preserve any built-in gain in her partnership interest.[41]

Returning to the *ABC* partnership's $10 cash distribution, each partner would reduce her outside basis by $10, from $170 to $160, as

39. I.R.C. § 731(a)(1). As will be discussed *infra* Part II.C, Congress has created numerous exceptions to this general rule, each requiring a partner to recognize gain on a distribution. One such exception warrants mention at this point: if a partner receives a cash distribution in excess of her outside basis, she is required to recognize a gain equal to such excess cash distribution. *Id.* The recognition of gain in this instance is essential because a basis adjustment cannot preserve the built-in gain in the distributee partner's partnership interest.

40. *Id.* § 733.

41. *Id.* A partnership distribution is treated as a recognition event for book purposes. When a partner receives a distribution, she thus reduces her capital account by the amount of cash or the fair market value of the property received in the distribution. Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1).

part of the transaction.[42] In doing so, the basis reduction would preserve the pre-distribution built-in gain in each partner's respective partnership interest. Before the distribution, each partner had a $30 built-in gain in her partnership interest, which had a fair market value of $200 and a basis of $170. After the distribution, each partner has $10 of cash and a partnership interest worth $190.[43] In order to preserve the $30 of pre-distribution built-in gain, each partner's outside basis must be reduced by $10. The partnership would thus have the following post-distribution balance sheet:

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Cash	470	470	A	160	190
Redacre	10	100	B	160	190
			C	160	190
Total	480	570		480	570

This distribution would not alter the partner's respective interests in the partnership; each partner would remain an equal one-third partner in the partnership. It is simply a means of transferring a ratable portion of the partnership's previously taxed income to each partner.[44] Considered in this light, treating this type of operating distribution as a nonrecognition transaction is entirely consistent with subchapter K's pass-through function, ensuring a single level of tax on the partnership's income.

Subchapter K's distribution provisions become more challenging when the distribution involves appreciated property. The

42. I.R.C. § 733. In this instance, *C* would also reduce her capital account by $10, the amount of cash received in the distribution. Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1).

43. The $10 cash distribution reduced the fair market value of each partner's partnership interest by $10, from $200 to $190.

44. Since its formation, the partnership has earned $210 of taxable income, and each partner has paid tax on her $70 allocated share of such income. The $10 cash distribution is best viewed as the transfer of a portion of these previously taxed funds to the partners that incurred the corresponding tax liability.

provisions remain grounded in nonrecognition; hence, any built-in gains will be deferred until a future disposition occurs. But subchapter K's nonrecognition premise must now operate at two levels—the partnership level and the partner level—in each case deferring the proper amount of pre-distribution built-in gain through basis adjustments.

At the partnership level, a distribution of property will not trigger immediate taxation of any built-in gain in the distributed property to the partnership.[45] This built-in gain will instead be deferred, recognized by the distributee partner on a future disposition of the distributed property. To implement this nonrecognition rule, the distributee partner takes a basis in the distributed property equal to the partnership's basis in the property immediately before the transaction.[46] In doing so, subchapter K ensures the requisite continuity in the relationship between the distributed property's fair market value and basis, thus preserving the aggregate amount of pre-distribution built-in gain.

To illustrate, let's return to the *ABC* partnership. This time, let's assume that *C* requires funds to finance her son's law school education, and she wishes to reduce her interest in the partnership through a partially liquidating distribution. The partnership therefore distributes Redacre to her and, in exchange, reduces her partnership interest from one-third to one-fifth.[47] Immediately before the

45. I.R.C. § 731(b). As previously noted, the capital account treatment of distributions is different, grounded in a recognition rule. When a partnership distributes property to a partner, any economic appreciation reflected in the property is recognized by the partnership and allocated among all the partners based on their pre-distribution sharing arrangement, thereby increasing each partner's capital account. Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1). Once the partnership makes this adjustment, it then reduces the distributee partner's capital account by the fair market value of the distributed property. *Id.*

46. I.R.C. § 732(a)(1). There is, however, a limitation on this "transferred" basis rule. The basis a distributee partner takes in the distributed property may not exceed the difference between her pre-distribution outside basis and the amount, if any, of cash received in the distribution. *Id.* § 732(a)(2). If this limitation applies, the distributee partner's basis in the distributed property will not equal the partnership's pre-distribution basis in such property; hence, the basis adjustment will not succeed in preserving all of the built-in gain in the distributed property. For a discussion of the challenges created by this "loss" of partnership basis, see *infra* note 121.

47. Before the distribution, the partnership is worth $600; it holds $500 in cash and Redacre with a fair market value of $100. *C*'s partnership interest, in turn, has a fair market value of $200. Accordingly, *C*'s interest in the partnership would be a one-third interest ($200 fair market value of partnership interest / $600 fair market value of partnership). After the distribution, the partnership is worth only $500, having distributed Redacre to *C*. Likewise, the receipt of Redacre reduced the fair market value of *C*'s partnership interest by $100, from $200 to $100. *C*'s interest

distribution, the partnership has the following balance sheet:

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Cash	500	500	A	170	200
Redacre	10	100	B	170	200
			C	170	200
Total	510	600		510	600

At this time, there is a $90 built-in gain in Redacre, which is reflected in the difference between the property's $100 fair market value and its $10 basis. Because subchapter K treats distributions as nonrecognition events, the partnership would not recognize this $90 gain when it transfers Redacre to *C*.[48] The $90 built-in gain would be deferred, with *C* now recognizing this gain on a future sale of Redacre. To that end, *C* would take a $10 basis in Redacre, which equals the partnership's pre-distribution basis in the property.[49] The basis adjustment would thus preserve Redacre's pre-distribution built-in gain. The only difference would be the incidence of tax, now falling on *C* rather than the partnership. If Redacre were sold for $100 after the distribution, *C*, not the partnership, would recognize a $90 gain.

Nonrecognition similarly drives the tax consequences at the partner level. As previously discussed, the distributee partner does not recognize any of the built-in gain in her partnership interest at the time of distribution.[50] This gain is instead deferred for future taxation through a combination of basis adjustments made to her partnership interest and the distributed property. Specifically, the partner takes a basis in the distributed property equal to the partnership's pre-distribution basis in the property and reduces her outside basis by a

in the partnership is thus one-fifth ($100 fair market value of partnership interest / $500 fair market value of partnership).

48. I.R.C. § 731(b).

49. *Id.* § 732(a)(1).

50. *See supra* note 39.

corresponding amount.[51] These basis adjustments are designed to ensure that the post-distribution built-in gain reflected in the distributed property and the distributee partner's partnership interest, taken together, equal the pre-distribution built-in gain reflected in her partnership interest.[52]

In the case of a complete liquidating distribution, subchapter K's distribution provisions, particularly those governing basis adjustments, operate differently. They remain grounded in nonrecognition, but they must now reflect the fact that the distributee partner no longer has an interest in the partnership. As a result, all of the pre-distribution built-in gain reflected in the distributee partner's partnership interest must now be reflected in the distributed property. The distributee partner thus takes a basis in the distributed property equal to her outside basis.[53] Otherwise, a complete liquidating distribution is treated like any other distribution.[54]

To illustrate the consequences to the distributee partner, let's return to the *ABC* partnership's partially liquidating distribution to *C*. Immediately before this distribution, *C* held a partnership interest with a fair market value of $200 and an outside basis of $170; hence, there was a $30 built-in gain in her interest. The distribution would not trigger recognition of this gain.[55] Taxation would instead be

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51. I.R.C. §§ 732(a)(1), 733.

52. As discussed *supra* note 46, these basis adjustments do not always work perfectly; hence, challenges often arise.

53. I.R.C. § 732(b). The distributee partner thus often takes a basis in the distributed property that is different from the partnership's pre-distribution basis in such property. As a result, subchapter K's transferred basis provisions may again fail to preserve the pre-distribution built-in gain in the distributed property. For a discussion of the problems created by this basis imbalance, see *infra* note 121.

54. *See supra* note 33. From a capital account perspective, there is a sharp difference in the treatment of liquidating and non-liquidating distributions. If a partnership makes a distribution in complete or partial liquidation of a partnership interest, the partnership may elect to "rebook" its property. Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(ii). That is, the partnership may revalue all of its property, thereby recognizing any economic appreciation in the property. These "book" gains would then be allocated among the partners based on their pre-distribution sharing arrangement. *Id.* § 1.704-1(b)(2)(iv)(f)(1), (2). A rebooking thus allows all of the partners to share in the economic gains of the partnership based on their pre-distribution sharing arrangement in anticipation of a change in such arrangement, effectively "locking in" each partner's share of the partnership's pre-distribution economic gains. Put another way, it reflects the fact that a liquidating distribution—whether complete or partial—has a transformative effect on the partnership. For a more detailed discussion of partnership rebookings, see generally MCKEE ET AL., *supra* note 10, ¶ 11.02[2][c][ii]; ARTHUR B. WILLIS & PHILIP F. POSTLEWAITE, PARTNERSHIP TAXATION ¶ 10.04[3][c] (7th ed. 2011) (2012).

55. I.R.C. § 731(a)(1).

deferred, with the $30 of appreciation preserved through *C*'s post-distribution basis in Redacre and her partnership interest. As previously discussed, *C* would take a $10 basis in Redacre.[56] She would thus decrease her outside basis by a corresponding amount, reducing it from $170 to $160.[57] After the distribution, the partnership would have the following balance sheet:

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Cash	500	500	A	170	200
			B	170	200
			C	160	100
Total	500	500		500	500

Taken together, *C*'s bases in Redacre and her post-distribution partnership interest would preserve the $30 built-in gain in her pre-distribution partnership interest. There would be a $90 built-in gain reflected in Redacre, and *C* would recognize this gain if she were to sell the property. Her partnership interest, in contrast, would be worth $100 with an outside basis of $160. If *C* were to sell her partnership interest, she would recognize a $60 loss. When these results are combined, *C* would have a net built-in gain of $30 in her post-distribution property, consistent with the pre-distribution built-in gain in her partnership interest.

More generally, subchapter K's nonrecognition-based distribution system is designed to preserve the aggregate amount of pre-distribution built-in gain through the distributee partner's post-distribution bases in the distributed property and her partnership interest. This system, however, does not focus on the identity of the taxpayer or the rate of tax that will be applied to such built-in gains on a subsequent sale. Yet changes in the taxpayer or the tax rate raise equitable concerns. Indeed, as will be discussed below, it is equally

56. *See supra* note 49.
57. I.R.C. § 733.

important that distributions preserve the amount and character of each partner's share of the partnership's pre-distribution built-in gains.[58]

These equitable concerns are best explored by returning to the aggregate theory of partnerships, where each partner is treated as owning her respective share of each item of partnership property.[59] As a direct owner of the partnership's property, each partner would be entitled to the benefits and burdens associated with such property, including any built-in gain in the property. Because subchapter K treats a distribution as a nonrecognition event, the transaction should have no effect on the partners' interest in any item of partnership property. In fact, equity would seem to require that these pre-distribution built-in gains be preserved on a property-by-property basis.

To illustrate, let's return to the *ABC* partnership and its partial liquidating distribution to *C*. Recall that there was a $90 built-in gain in Redacre immediately before the distribution, and each partner's share of this gain was $30.[60] Under the aggregate theory of partnerships, each partner would thus be treated as if she directly owned a one-third interest in Redacre, with a fair market value of $33.33 and a basis of $3.33.[61] Accordingly, there would be a $30 built-in gain in each partner's interest in Redacre.

The partnership's distribution of Redacre would alter these shares. *C* would now own Redacre in her individual capacity; thus she alone would bear the tax burden associated with Redacre. If *C* were to sell Redacre for its fair market value of $100, she would recognize a $90 gain. Put another way, the distribution would increase her share of Redacre's built-in gain by $60, from $30 to $90. Likewise, the distribution would reduce *A*'s and *B*'s share of

58. *See infra* Part II.B.

59. *See supra* note 20 and accompanying text.

60. Before the distribution, Redacre had a fair market value of $100 and a basis of $10. If the partnership had sold Redacre rather than distributing it to *C*, it would have recognized a $90 capital gain. I.R.C. §§ 1001, 1221(a). This gain, in turn, would have been allocated equally among the partners: $30 each. *Id.* § 704(b).

61. The fair market value of Redacre was $100. If the property were divided into three equal interests, each interest would be worth $33.33 ($100 fair market value * 1/3). Likewise, the basis in each interest would equal one-third of the partnership's basis in Redacre, or $3.33 ($10 basis * 1/3).

this built-in gain by a corresponding amount.[62] The distribution would allow *A* and *B* to dispose of their direct interests in Redacre in a tax-free manner, but it would fail to preserve their respective built-in gains. Rather, the distribution would shift these built-in gains to *C*.[63]

To summarize, subchapter K's original distribution system focused on preserving the aggregate amount of built-in gains reflected in the distributed property and the distributee partner's partnership interest. But this system was not sensitive to the identity of the taxpayer that would ultimately bear the corresponding federal tax liability. Although taxpayer identity raised equitable concerns, Congress did not believe that the related revenue stakes were particularly high.[64] Subchapter K's distribution system thus did not require that a distribution preserve the amount and character of each partner's share of the partnership's pre-distribution built-in gains. Subchapter K instead left the enforcement of these equitable concerns largely up to partnerships themselves.[65]

B. Use and Abuse of Partnership Distributions

Congress quickly came to understand its error; the revenue stakes in subchapter K were in fact high, and partnerships could not be trusted to self-police. In the absence of equity-based provisions, partnerships used a variety of techniques to structure distributions

62. Immediately before the distribution, *A*'s and *B*'s respective shares of Redacre's built-in gain were $30. After the distribution, the partnership no longer holds Redacre; hence, their shares of the property's tax appreciation would be zero.

63. It is, however, important to note that this shift is temporary, reversing itself on each partner's sale or liquidation of her partnership interest. Nonetheless, this type of income shifting, and the resulting deferral effect, remain problematic because the offsetting allocations may not occur for many years, if at all. The longer it takes to reverse the income shift, the more the deferral effect begins to look like a permanent exemption from the federal income tax. William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1124 (1974).

64. *See* H.R. REP. NO. 83-1337, at 65 (1954); S. REP. NO. 83-1622, at 89 (1954); *see also* J. Paul Jackson et al., *A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners—American Law Institute Draft*, 9 TAX L. REV. 109, 113 (1954) [hereinafter Jackson et al., *1954 American Law Institute Draft*]; J. Paul Jackson et al., *The Internal Revenue Code of 1954: Partnerships*, 54 COLUM. L. REV. 1183, 1183 (1954) [hereinafter Jackson et al., *Internal Revenue Code of 1954*].

65. At the time of subchapter K's codification, Congress was in fact concerned with transactions designed to convert ordinary income into preferentially treated capital gains. As will be discussed *infra* Part II.B.2, subchapter K's original provisions did focus on preventing improper character conversions. I.R.C. §§ 731(a)(2), 735, 751(b) (1954).

that improperly reduced the partners' aggregate tax burden in violation of equitable norms. This subpart uses the *ABC* partnership to explore three such abuses: income shifting, character conversions, and income avoidance.[66]

1. Income Shifting

A distribution can be used to shift income among partners, improperly altering each partner's share of pre-distribution built-in gain. To illustrate, let's return to the previous example involving the *ABC* partnership. This time, however, let's assume that the partnership holds inventory ("Inventory") rather than Redacre, and the partnership distributes the Inventory to *C* in partial liquidation of her partnership interest.[67] At the time of the distribution, the Inventory has a fair market value of $100 and a basis of $10.

Neither *C* nor the partnership would recognize any gain on the distribution, and *C* would take a basis of $10 in the Inventory.[68] In doing so, subchapter K's distribution system would preserve the Inventory's $90 aggregate built-in gain for future recognition; if *C* were to sell the property for its post-distribution fair market value of $100, she would recognize a $90 gain.

Even so, this distribution would change the incidence of tax, shifting $60 of income from *A* and *B*, the non-distributee partners, to *C*, the distributee partner. Like the previous example, each partner's share of the Inventory's pre-distribution built-in gain was $30.[69] Yet after the distribution, *C* would bear the tax burden for the entire $90 of gain. The distribution would thus absolve *A* and *B* of responsibility for their respective $30 shares of the Inventory's pre-distribution built-in gain. Assuming that *A* and *B* are subject to a higher rate of tax than *C*, this income shift would produce a net tax

66. This subpart offers readers a simple introduction to the primary abuses involving partnership distributions. It is important to note that subchapter K does include a variety of anti-abuse provisions designed to prevent many of these abuses, and these provisions will be discussed in greater detail *infra* Part II.C. For purposes of this subpart, however, I will assume that subchapter K does not include any anti-abuse provisions. My goal here is simply to illustrate the tax shelter opportunities created by a distribution system that is grounded in a nonrecognition rule.

67. As noted, this subpart disregards subchapter K's current smorgasbord of anti-abuse provisions. Nonetheless, one such provision, section 751(b), would in fact apply to this transaction. Section 751(b) will be discussed in greater detail *infra* Part II.C.3.

68. *See supra* notes 48–51 and accompanying text.

69. *See supra* note 60.

savings for the partners.[70] More broadly, shifting income from high bracket partners to low bracket partners benefits the partnership as a whole by decreasing the aggregate tax liability associated with the future sale of the distributed property. But it does so at the expense of the public at large, depriving the federal government of tax revenues.[71]

2. Character Conversions

A distribution can also be used to convert ordinary income into preferentially treated capital gains. This type of transaction was particularly popular during subchapter K's early years when individual income tax rates were as high as 91 percent, yet the capital gains rate was only 25 percent.[72] To the extent that subchapter K's original provisions affirmatively focused on equity, it was to address this type of character converting distribution.[73]

Returning again to the *ABC* partnership's distribution of the Inventory, the transaction also involved an improper character conversion. If the partnership had sold the Inventory instead of distributing it to *C*, it would have recognized a $90 gain, and this gain would have been ordinary.[74] Once *C* takes possession of the Inventory, however, the character of any gain recognized on a subsequent sale would be determined based on *C*'s use of the property. Assuming that *C* is not a dealer in Inventory, the property would likely qualify as a capital asset.[75] Any sale of the Inventory by *C* for its then fair market value of $100 would thus result in a $90 capital gain.[76]

By converting a pre-distribution ordinary gain into a post-distribution capital gain, the partnership would reduce the tax rate applicable to any gain recognized on the Inventory's sale. Like income shifting, character conversions reduce the partners' aggregate

70. For an example of the benefit achieved through income shifting, see *supra* note 25.

71. As discussed *supra* note 63, this income shift is temporary, reversing itself on a partner's sale or liquidation of her partnership interest.

72. I.R.C. §§ 1(a) (providing tax rates for individuals), 1201(b) (providing capital gains rate for individuals) (1954).

73. *See infra* note 80.

74. I.R.C. §§ 702(b), 1221(a)(1) (2006).

75. I.R.C. § 1221(a).

76. Subchapter K does in fact contain a series of anti-abuse provisions designed to prevent this type of character conversion. *Id.* §§ 735(a), 751(b). For a discussion of these provisions, see *infra* note 80 (section 735) and Part II.C.3 (section 751(b)).

tax liability. Indeed, distributions often involve both of these abuses, converting the character of a built-in gain and shifting it among the partners. In these instances, subchapter K's distribution system fails to preserve both the amount and the character of the partners' respective shares of the partnership's pre-distribution built-in gain.

3. Income Avoidance

The final distribution-related abuse involves distributions that are part of a coordinated plan to disguise taxable property dispositions. In these transactions, a partner's contribution of property to the partnership is followed by a distribution of property to the same partner. Although the contribution and distribution, taken together, would otherwise effect a property disposition, subchapter K treats both transactions as nonrecognition events, thereby deferring the recognition of any built-in gain.[77] By using the partnership as a conduit, the partner is able to achieve a result often impossible outside of subchapter K—a tax-free property disposition.

Returning to the *ABC* partnership, imagine that *B* owns additional inventory in her individual capacity, and she wishes to sell this property to the partnership. The additional inventory is worth \$200 and has a basis of \$150, and *B* wants to avoid recognizing the property's \$50 built-in gain on the disposition. Accordingly, *B* and the partnership "disguise" this disposition as follows: *B* would first contribute the additional inventory to the partnership, and the partnership would subsequently distribute \$200 of cash to *B*.[78] Because both transactions are treated as nonrecognition events, neither the contribution nor the distribution would trigger recognition of the \$50 built-in gain attributable to the additional inventory.[79] This

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77. Contributions to a partnership, like distributions from a partnership, are treated as nonrecognition transactions under subchapter K. I.R.C. § 721(a). Neither the contributing partner nor the partnership recognizes gain on the contribution of property to a partnership in exchange for a partnership interest. *Id.* Any built-in gain in the contributed property is instead deferred for future recognition on a subsequent sale of either the contributed property or the contributing partner's partnership interest. The preservation of this built-in gain is achieved through basis adjustments at both the partner and the partnership level. *Id.* §§ 722 (contributing partner's outside basis), 723 (partnership's basis in contributed property).

78. Like the aforementioned anti-abuse provisions addressing income and character converting transactions, subchapter K also contains provisions that attempt to prevent this type of disguised sale. *Id.* §§ 707(a)(2)(B), 737. For a discussion of these provisions, see *infra* notes 82 (section 707(a)(2)(B)) and 85 (section 737).

79. If *B* were to contribute the additional inventory to the partnership, neither she nor the partnership would recognize any gain on the transaction. I.R.C. § 721(a). Instead, the \$50 built-in

coordinated transaction would thus allow *B* to avoid recognizing gain on what is, in substance, a taxable property disposition.

C. Government Responses

Nonrecognition in partnership distributions proved problematic from the outset, allowing partnerships to manipulate deferred built-in gains to their partners' advantage. When subchapter K was codified, Congress considered character conversions to be its most pressing concern and responded accordingly.[80] Over time, however, the difference between the capital gains rate and the highest individual income tax rate shrank; hence, the danger associated with character conversions diminished. At the same time, Congress came to appreciate the tremendous public cost associated with income shifting and avoidance.[81]

Throughout this period, Congress responded aggressively to abusive distributions, enacting various anti-abuse provisions. A

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gain would be preserved through a series of basis adjustments. *Id.* §§ 722, 723. To that end, *B* would increase her outside basis by $150, from $170 to $320. *Id.* § 722. Likewise, the partnership would take a basis of $150 in the additional inventory. *Id.* § 723. When the partnership then distributes $200 in cash to *B*, the transaction would again be treated as a tax-free event: neither *B* nor the partnership would recognize a gain. *Id.* § 731(a)(1), (b). *B* would adjust her outside basis accordingly, reducing it from $320 to $120. *Id.* § 733.

80. *See, e.g.*, Jackson et al., *1954 American Law Institute Draft*, *supra* note 64, at 154. Examples of subchapter K's original character conversion-focused provisions include sections 731(a)(1), 735, and 751(b). I.R.C. §§ 731(a)(2), 735(a), 751(b) (1954). The section 751(b) disproportionate distribution rule will be discussed in greater detail *infra* Part II.C.3. Section 735 deals with a distributee partner's sale of property received in a distribution. If a partnership distributes certain types of property to a partner that would generate ordinary income if sold by the partnership, then the distributee partner's subsequent sale of such property will also generate ordinary income. I.R.C. § 735(a) (2006). The duration of this "taint" depends on the particular type of "ordinary" asset distributed. *Id.* § 735(a)(1) (indefinite taint for assets treated as "unrealized receivables," as defined in section 751(c)), (a)(2) (five-year taint for assets treated as "inventory," as defined in section 751(d)). For a more detailed discussion of section 735, see generally MCKEE ET AL., *supra* note 10, ¶ 20.02; WILLIS & POSTLEWAITE, *supra* note 54, ¶ 13.04.

Section 731(a)(2), in contrast, addresses the alternate side of character conversions, preventing the conversion of a capital loss into a preferentially treated ordinary loss through a complete liquidating distribution. I.R.C. § 731(a)(2). It applies to complete liquidating distributions where the distributee partner receives a combination of cash and property that, if sold by the partnership, would generate ordinary income. *Id.* In these instances, section 731(a)(2) requires the distributee partner to recognize a loss equal to the excess of (1) the distributee partner's pre-distribution outside basis over (2) the sum of the basis that she takes in the distributed property and the amount of any cash received in the distribution. *Id.* For a more detailed discussion of section 731(a)(2), see generally MCKEE ET AL., *supra* note 10, ¶ 19.05; WILLIS & POSTLEWAITE, *supra* note 54, ¶ 13.02[2][c].

81. *See, e.g.*, AM. LAW INST., MEMORANDUM NO. 3, *supra* note 11, at 30–31; Andrews, *supra* note 7, at 4.

complex patchwork of provisions emerged to combat these sheltering transactions. Although diverse in operation, these anti-abuse provisions share two common characteristics: their design and their rejection of nonrecognition. After discussing these elements, this subpart will provide an example of subchapter K's anti-abuse provisions in operation, using the section 751(b) disproportionate distribution rule as a guide through the maze of partnership distributions.

1. Design

In large part, Congress's desire to reconcile flexibility and equity in partnership distributions was the driving force behind the design of these anti-abuse provisions. The goal was to develop provisions that targeted specific abuses without infringing on legitimate partnership distributions. The result was narrowly tailored, intricate provisions designed to pinpoint particular tax shelters through a combination of mathematical rules and open-textured standards.[82] Put another way, these anti-abuse provisions were terribly complicated.

At the same time, these provisions were often reactive, combating the last tax shelter rather than the next tax shelter. Congress perpetually found itself behind the tax shelter market, drafting an ad hoc series of targeted responses instead of developing a comprehensive, forward-thinking approach to abusive

82. *See, e.g.*, I.R.C. §§ 707(a)(2)(B), 751(b). Section 751(b) will be discussed *infra* Part II.C.3. The section 707(a)(2)(B) disguised sale rule provides that a contribution and distribution will be recast as a taxable disposition between the partner and the partnership if, when considered together, the two transactions are more properly characterized as a sale. I.R.C. § 707(a)(2)(B). The determination of whether a contribution and distribution are, in substance, a sale is made by using a standards-based approach. Treas. Reg. § 1.707-3(b)(2). A partnership is required to consider all relevant facts and circumstances in making this determination, but the regulation provides a list of ten factors that may lead to the conclusion that a coordinated contribution and distribution are, in fact, a sale. *Id.* Of particular importance, these factors focus on whether the partner's receipt of the distribution was subject to the entrepreneurial risks of the partnership's operations. *Id.* In order to ease the burden of this standard, the regulation also includes two rebuttable presumptions: (1) a contribution and distribution occurring within a two-year period are presumed to be a disguised sale; and (2) a contribution and distribution occurring more than two years apart are presumed to be independent transactions. *Id.* § 1.707–3(c)(1), (d). For a more detailed discussion of the section 707(a)(2)(B) disguised sale rule, see generally MCKEE ET AL., *supra* note 10, ¶ 14.02[3][B]; WILLIS & POSTLEWAITE, *supra* note 54, ¶ 13.02[7].

distributions.[83] As a result, these anti-abuse provisions lack systemic coherence and offer too little guidance for law-abiding partnerships.

2. Erosion of Nonrecognition

Operationally, the last half-century of anti-abuse provisions have largely relied on recognition rules that require the distributee partner or the partnership to recognize gain at the time of distribution. By cutting off deferral at distribution, these anti-abuse provisions eliminate the built-in gains necessary to shift income, convert character, or avoid gain recognition. Although their approaches to recognition vary, all of these anti-abuse provisions strive to recast the underlying transaction in a manner that better reflects its commercial substance. Some provisions, such as the section 751(b) disproportionate distribution rule and the section 707(a)(2)(B) disguised sale rule, treat the distribution as a taxable sale or exchange between the partnership and the distributee partner.[84] In these transactions, the recharacterized distribution may trigger gain recognition by both the partnership and the distributee partner. Other provisions adopt a narrower approach, only requiring the distributee partner to recognize gain.[85] In these instances, the recognized gain is

83. In 1994, IRS Deputy Associate Chief Counsel Monte Jackel described this problem in the following manner: "We're talking about the world of today. There's been too many transactions that are too close to the line—results and opinions about the interaction of rules which we believe are inappropriate . . . . We need help in crafting a rule to police the partnership area. We have decided as an institution that we are not going to pursue these problems on a case-by-case basis anymore." Lee A. Sheppard, *Partnership Antiabuse Rule: Dirty Minds Meet Mrs. Gregory*, 64 TAX NOTES 295, 295 (1994).

84. For a discussion of the section 751(b) disproportionate distribution rule, see *infra* Part II.C.3. Likewise, for a discussion of the section 707(a)(2)(B) disguised sale rule, see *supra* note 82.

85. I.R.C. §§ 704(c)(1)(B), 737. Section 704(c)(1)(B) was designed to curtail transactions where the partnership is used as a "mixing bowl" to shift a built-in gain attributable to contributed property from the contributing partner to another partner. To that end, if a partner contributes property to a partnership and, within the seven-year period following the contribution, the contributed property is distributed to another partner, section 704(c)(1)(B) requires the contributing partner to recognize the pre-contribution gain. *Id.* § 704(c)(1)(B)(i). For a detailed discussion of the section 704(c)(1)(B) mixing bowl rule, see generally MCKEE ET AL., *supra* note 10, ¶ 11.04[4]; WILLIS & POSTLEWAITE ET AL., *supra* note 54, ¶ 13.02[6][b].

In contrast, the section 737 mixing bowl rule operates as a backstop to the section 707(a)(2)(B) disguised sale rule, which is discussed *supra* note 82. It applies to a partner that contributes property to a partnership and receives a distribution of different property during the succeeding seven-year period. I.R.C. § 737(a). If applicable, section 737 requires a partner to recognize a gain that is intended to approximate the gain that she would have recognized on a taxable disposition of the property previously contributed to the partnership. For a detailed typically computed by reference to a hypothetical sale of partnership property at its fair market value immediately before the distribution.[86] To the extent that the partnership would have allocated any hypothetical gain to the distributee partner, these anti-abuse provisions require her to recognize such gain at the time of distribution.[87]

3. An Example: Section 751(b)

Section 751(b) is the oldest and most troublesome of Congress's recognition-based anti-abuse provisions, recasting "disproportionate" distributions as taxable exchanges between the partnership and the distributee partner. Congress originally designed section 751(b) to combat character conversions, but over time it has become a bulwark against a diverse array of abuses, including income shifting and excessive deferral.[88] Despite its expanded role in fighting abusive distributions, section 751(b) exists in virtually its original form.[89] It

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discussion of the section 737 mixing bowl rule, see generally MCKEE ET AL., *supra* note 10, ¶ 19.08; WILLIS & POSTLEWAITE, *supra* note 54, ¶ 13.02[1][a][v].

86. I.R.C. §§ 704(c)(1)(B)(i), 737(b).

87. *Id.*; *see also* § 731(c) (treating marketable securities as money for purposes of determining the tax consequences to a distributee partner).

88. H.R. REP. NO. 83-1337, at 71 (1954); S. REP. NO. 83-1622, at 98–99 (1954); H.R. REP. NO. 83-2543, at 64–65 (1954) (Conf. Rep.), *reprinted in* 1954 U.S.C.C.A.N. 5280, 5325–26; *see also, e.g.*, AM. LAW INST., SUBCHAPTER K PROJECT, *supra* note 11, at 49; Andrews, *supra* note 7, at 4 ("The original purpose for this provision had primarily to do with the distinction between capital gain and ordinary income rates, more than timing of gain recognition, but it currently functions to set an important, though inadequate limit on unreasonable postponement of tax."). Alongside distribution-related character concerns, section 751(b) originally reflected parallel concerns regarding the treatment of sales of partnership interests. From an economic perspective, a complete liquidating distribution of cash to a retiring partner is the equivalent of a sale of the retiring partner's interest. The only difference is the identity of the purchaser—the remaining partners, in the case of a complete liquidating distribution, versus a third party, in the case of a sale. When subchapter K was originally codified, it contained a series of provisions designed to prevent character conversions through sales of partnership interests. I.R.C. §§ 741, 751(a) (1954). In order to prevent partnerships from avoiding these "collapsible partnership" provisions through the use of distributions, Subchapter K's original distribution system required comparable provisions. Section 751(b), it was hoped, would perform that function. *See, e.g.*, Paul Little, *Partnership Distributions Under the Internal Revenue Code of 1954 (First Installment)*, 10 TAX LAW REV. 161, 182–83 (1954). For an excellent history of section 751(b), see generally MCKEE ET AL., *supra* note 10, ¶ 21.02[2]; Burke, *supra* note 11, at 680–93; Hanna, *supra* note 11, at 469–85.

89. I.R.C. § 751(b) (1954); Treas. Reg. § 1.751-1(b) (1956). In 2006, the Treasury requested comments regarding the possible revision of section 751(b). I.R.S. Notice 2006-14, 2006-1 C.B. 498. In explaining the rationale behind its review of section 751(b), it noted that "the current regulations under Section 751(b) were published in 1956 and have not been amended to reflect significant changes in subchapter K and in the operations of contemporary partnerships." *Id.* at 499. Eight years later, the Treasury has yet to issue proposed regulations under section 751(b).

thus reflects an erstwhile era of partnership distributions, failing to account for the seismic shifts in modern partnerships and partnership tax shelters.

Section 751(b) first requires a partnership to divide its assets into two categories—"hot assets" and "cold assets." Broadly speaking, hot assets are assets that would generate ordinary income if sold by the partnership, such as inventory and accounts receivable; everything else is a cold asset.[90] To illustrate this division, let's return to the *ABC* partnership. Let's also assume that the partnership has three assets: $200 in cash, investment property ("Blueacre") with a fair market value and basis of $300, and Inventory with a fair market value of $100 and a basis of $10. The Inventory is treated as a hot asset under section 751(b) because its sale by the partnership would result in ordinary income.[91] The cash and Blueacre, in contrast, are cold assets.

Once the partnership has properly divided its assets, it must determine if a particular distribution is "disproportionate," thus triggering section 751(b)'s recognition rule. A distribution is disproportionate if the distributee partner receives more than her share of the partnership's hot assets or cold assets, in each case, as measured by their gross asset value.[92] If disproportionate, section 751(b) recasts the distribution as a taxable exchange between the distributee partner and the partnership.[93]

Consider again the *ABC* partnership. Assume that *C* wishes to retire from the partnership; hence, the partnership transfers $200 in

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90. I.R.C. § 751(b). Hot assets include two categories of assets—unrealized receivables and substantially appreciated inventory. *Id.* Unrealized receivables are any rights, not previously included in income under the taxpayer's method of accounting, to payment for services rendered or payment for goods delivered to the extent that such payment would not be treated as an amount received from the disposition of a capital asset. *Id.* § 751(c). Inventory, in contrast, is defined broadly to include (1) property that would be included in a taxpayer's inventory if on hand at the close of the taxable year; (2) any other property of the partnership that, if disposed of, would not be considered a capital asset or section 1231 property; and (3) any other property of the partnership that, if held by the distributee partner, would fall within this definition of "inventory." *Id.* § 751(d). Inventory, in turn, is substantially appreciated if its aggregate fair market value exceeds 120 percent of its aggregate basis to the partnership. *Id.* § 751(b)(3)(A).

91. I.R.C. § 751(d)(1). The Inventory falls within the statutory definition of "inventory" because it would be included in inventory if the partnership held it at the end of the taxable year. *Id.* Additionally, the Inventory is treated as substantially appreciated inventory. *Id.* § 751(b)(3)(A). Its fair market value ($120) exceeds 120 percent of its basis ($10).

92. *Id.* § 751(b); Treas. Reg. § 1.751-1(g), exs. 2, 3.

93. I.R.C. § 751(b).

cash to her in a complete liquidating distribution.[94] This distribution would be disproportionate because *C* receives only cold assets—cash—in complete liquidation of her partnership interest. Put another way, *C*'s interest in the partnership's hot assets, as determined by their gross asset value, would decrease from $33.33 to $0.[95] Section 751(b) would therefore recharacterize the distribution as an exchange between *C* and the partnership, with *C* exchanging her one-third share of the Inventory for a larger share of the partnership's cash.[96]

To implement this exchange, section 751(b) breaks a distribution into three fictional transactions. Because the disproportionate distribution is recast as an exchange between the distributee partner and the partnership, the distributee partner first needs to obtain the property that she will be deemed to exchange for a portion of the property actually distributed to her. In the first imaginary transaction, the partnership thus distributes this property—the property that she relinquishes in the actual distribution—to the distributee partner.[97] In the previous example, section 751(b) would treat *C* as if she received a distribution of one-third of the

94. Immediately before this distribution, the partnership had the following balance sheet:

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Cash	200	200	A	170	200
Inventory	10	100	B	170	200
Blueacre	300	300	C	170	200
Total	510	600		510	600

95. *Id.* § 751(b)(1)(B); Treas. Reg. § 1.751-1(g), ex. 2. Immediately before the distribution, the partnership held Inventory with a fair market value of $100 and a basis of $10. As a one-third partner, *C* would be treated as having a one-third interest in the Inventory, with a fair market value of $33.33 ($100 fair market value * 1/3 interest) and a basis of $3.33 ($10 basis * 1/3).

96. More generally, when a distribution reduces a partner's share of the partnership's hot assets, section 751(b) treats the partner as if she exchanged all or a portion of her share of the partnership's hot assets for a larger share of the partnership's cold assets. I.R.C. § 751(b)(1)(B). Conversely, when a distribution increases a partner's share of the partnership's hot assets, section 751(b) treats the partner as if she exchanged all or a portion of her share of the partnership's cold assets for a larger share of the partnership's hot assets. *Id.* § 751(b)(1)(A).

In this transaction, *C* is also exchanging her one-third share of Blueacre for an increased share of the partnership's cash. This type of cold asset exchange is beyond section 751(b)'s scope because it does not involve an "exchange" of assets of differing character. It can, however, present income shifting concerns.

97. Treas. Reg. § 1.751-1(b)(3)(iii), (g), ex. 2(d)(1).

partnership's Inventory, with a fair market value of $33.33 and a basis of $3.33.[98] Neither *C* nor the partnership would recognize a gain on this first-step distribution.[99] *C* would instead take a basis of $3.33 in the Inventory and would adjust her outside basis accordingly, reducing it from $170 to $166.67.[100]

The second fictional transaction is the exchange, where the distributee partner exchanges the property received in the first-step distribution for a portion of the property involved in the actual distribution.[101] Returning to the *ABC* partnership, *C* would thus transfer the Inventory back to the partnership and, in exchange, she would receive $33.33 in cash from the partnership.[102] *C* would recognize a $30 ordinary gain on this exchange.[103] In contrast, the partnership would recognize no gain, treating the transaction as a cash purchase of the Inventory. It would, however, take a basis of $33.33 in this "newly acquired" Inventory, thus increasing its aggregate basis in the Inventory from $6.67 to $40.[104]

98. *See supra* note 95.

99. I.R.C. § 731(a)(1), (b).

100. *Id.* §§ 732(a)(1), 733. Immediately after this first imaginary transaction, the partnership would have the following balance sheet:

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Cash	200	200	A	170	200
Inventory	6.67	66.67	B	170	200
Blueacre	300	300	C	166.67	166.67
Total	506.67	566.67		506.67	566.67

At the partnership level, the balance sheet would also reflect the Inventory distributed to *C* in this first-step fictional transaction. Recall that the partnership held Inventory with a fair market value of $100 and a basis of $10 before the distribution. After the distribution, the partnership holds Inventory with a fair market value of $66.67 ($100 pre-distribution fair market value of Inventory less $33.33 fair market value of Inventory distributed) and a basis of $6.67 ($10 pre-distribution basis of Inventory less $3.33 basis of Inventory distributed). Treas. Reg. § 1.751-1(g), ex. 2(e)(2).

101. Treas. Reg. § 1.751-1(b)(3)(i), (g), ex. 2(c).

102. That is, *C* would be treated as if she sold Inventory with a fair market value of $33.33 and a basis of $3.33 to the partnership for cash. The partnership, in contrast, would be treated as if it purchased Inventory for $33.33 in cash.

103. I.R.C. § 1001; Treas. Reg. § 1.751-1(b)(3)(iii), (g), ex. 2(d)(1). The $30 of gain recognized by *C* reflects the difference between the Inventory's purchase price ($33.33) and *C*'s basis in the Inventory ($3.33).

104. I.R.C. § 1012; Treas. Reg. § 1.751-1(g), ex. (e)(1). The partnership had a basis of $6.67 in the portion of the Inventory that was not distributed to *C* in the first-step distribution. When

The third imaginary transaction represents the proportionate element of the actual transaction, with the partnership making a distribution of the remainder of the property actually distributed to the partner.[105] Returning to the *ABC* partnership, this final transaction would involve a $166.67 cash distribution to *C*. She has already received $33.33 in cash from the partnership; hence, an additional $166.67 is necessary to complete the actual $200 cash distribution. Neither *C* nor the partnership would recognize a gain on this distribution, and *C*'s outside basis would be reduced to zero.[106]

As this example illustrates, section 751(b) is unbelievably complicated. It involves a total of seven steps, three fictional transactions, and the artificial division of the partnership's assets into

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this basis is added to the $33.33 cost basis taken in the "exchanged" Inventory, the partnership would have a total basis of $40 in the Inventory. Immediately after the distribution, the partnership would have the following balance sheet:

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Cash	166.67	166.67	A	170	200
Inventory	40	100	B	170	200
Blueacre	300	300	C	166.67	166.67
Total	506.67	566.67		506.67	566.67

This fictional exchange has no effect on *C*'s partnership interest, only involving her interest in the Inventory distributed in the first-step transaction. Accordingly, the fair market value and basis of *C*'s partnership interest would remain unchanged.

105. Treas. Reg. § 1.751-1(g), ex. 2(d)(2).

106. I.R.C. §§ 731(a)–(b), 733; Treas. Reg. § 1.751-1(g), ex. 2(d)(2), (e)(2). Immediately after this final step, the partnership would have the following balance sheet:

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Inventory	40	100	A	170	200
Blueacre	300	300	B	170	200
Total	340	400		340	400

hot and cold categories.[107] And this example—a complete liquidating distribution—is the easy case.[108]

Nonetheless, it is important to note that, in this example, section 751(b) would correctly preserve the amount and character of each partner's share of the partnership's pre-distribution built-in gains. And it would do so by recasting the distribution as a taxable exchange between the partnership and the distributee partner. Before the distribution, each partner's share of the Inventory's pre-distribution built-in gain was $30, and this gain was ordinary.[109] Section 751(b) would force *C* to recognize her share of this pre-distribution ordinary gain, thereby preventing the distribution from shifting the built-in gain or converting its character.[110] In contrast, *A*'s and *B*'s shares of the Inventory's pre-distribution built-in gain would be preserved for future recognition. *A* and *B* would now be equal partners in a partnership holding Inventory with a fair market value of $100 and a basis of $40. A subsequent disposition of the Inventory would thus generate a $60 ordinary gain, which the partnership would allocate equally between *A* and *B*, $30 each.

Even so, section 751(b) is not a panacea. It does not always succeed in preserving the amount and character of the partners' shares of pre-distribution built-in gains. In fact, section 751(b), like

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107. *See supra* note 10.

108. In both theory and practice, partial liquidating distributions are the most challenging type of distributions. *See, e.g.*, AM. LAW INST., MEMORANDUM NO. 3, *supra* note 11, at 55–58; Andrews, *supra* note 7, at 57; Burke, *supra* note 11, at 710–17.

109. Before the distribution, the Inventory had a fair market value of $100 and a basis of $10. If the partnership had sold the Inventory rather than distributing it to *C*, it would have recognized a $90 ordinary gain on the sale. I.R.C. §§ 1001, 1221(a). This gain, in turn, would have been allocated equally among the partners, $30 each. *Id.* § 704(b).

110. Consider the tax consequences of this distribution if section 751(b) did not apply. The partnership would distribute $200 in cash to *C* in complete liquidation of her partnership interest. *C* would recognize a gain of $30 on the distribution because the amount of cash distributed ($200) is greater than her outside basis ($170). *Id.* § 731(a)(1). This gain, however, would be treated as a capital gain. *Id.* § 731(a). Accordingly, the distribution would effect a character conversion, transforming ordinary income into a capital gain. Likewise, the distribution would increase *A*'s and *B*'s respective shares of the Inventory's built-in gain. Before and after the distribution, there would be a $90 built-in gain reflected in the Inventory ($100 fair market value less $10 basis). If the partnership had sold the Inventory for its fair market value prior to the distribution, the three partners would have shared the resulting $90 gain equally, $30 each. After the distribution, *C* would no longer be a partner; therefore, *A* and *B* would share the resulting $90 gain equally, $45 each. The distribution would thus increase *A*'s and *B*'s respective shares of the Inventory's built-in gain by $15.

In addition to section 751(b), subchapter K has another, elective mechanism designed to address this problem of "lost" basis and the resulting increase in the remaining partners' shares of pre-distribution built-in gain. For a detailed discussion of this mechanism, see *infra* note 121.

many of subchapter K's anti-abuse provisions, often works quite poorly. The next subpart addresses this problem and its impact on partnership distributions.

D. Partnership Distributions Today

Partnership distributions today are flawed in both theory and practice. The problem with partnership distributions is first principles—the tax treatment of distributions, especially liquidating distributions, does not reflect the commercial reality of these transactions. Congress and the Treasury have thus spent the last half-century trying to manage this disconnect, attempting to combat the resulting tax shelters while preserving subchapter K's flexibility. Yet these efforts have largely failed: the law of partnership distributions is now complicated, inequitable, and unstable. Partner compliance, in turn, is declining at both extremes of the partnership spectrum, with well-intentioned partnerships struggling to understand subchapter K and sheltering partnerships finding opportunity in its dysfunctionality.

1. The Commercial Reality Gap

There is a deep divide between subchapter K's treatment of partnership distributions and their commercial reality. As previously discussed, partnerships make distributions for myriad reasons, and their effects on a partnership and the relationship among its partners vary accordingly.[111] On one hand, operating distributions have very little impact on a partnership. The partners receive a proportionate share of the partnership's previously taxed income; hence, their respective interests in the partnership remain unchanged. On another hand, liquidating distributions are economically transformative events, where a partner terminates all or a portion of her investment in the partnership.

Yet all distributions are treated the same for tax purposes, subject to a singular nonrecognition-based set of tax provisions. In doing so, subchapter K elevates form over substance, focusing on the formal trait shared by these distributions—the transfer of cash or property from partnership to partner—instead of the commercial substance of these economically diverse transactions. Under this

111. *See supra* notes 31–33 and accompanying text.

uniform approach, form thus masks the foundational divide between operating distributions and liquidating distributions. By presumptively treating all distributions as nonrecognition transactions, subchapter K mistreats those distributions that are economically significant, namely, complete and partial liquidating distributions.

Simply put, grounding the tax treatment of liquidating distributions in a nonrecognition rule is inconsistent with the commercial reality of these transactions. As a general matter, nonrecognition is appropriate when a taxpayer's investment in an enterprise is continuing.[112] The classic example is a like-kind exchange.[113] If a taxpayer were to exchange a real estate investment in Wisconsin for a similar real estate investment in Pennsylvania, nonrecognition would likely be proper because the taxpayer's investment is continuing, albeit in a slightly modified form. The taxpayer would not be taxed on any built-in gain in the Wisconsin property; instead, the gain would be deferred for future recognition on her sale of the Pennsylvania property.[114] If, however, the taxpayer sold her real estate investment in Wisconsin for cash or exchanged it for an entirely different kind of property, like a helicopter, nonrecognition would no longer be appropriate. Here, the taxpayer would be terminating her real estate investment and should therefore recognize any built-in gain in the Wisconsin property, consistent with fundamental tax principals.[115]

Similarly, liquidating distributions involve the termination of a partner's investment in a partnership. In these transactions, the distributee partner receives cash or property from the partnership and, in exchange, relinquishes all or a portion of her interest in the partnership and its property.[116] The liquidating distribution thus

112. *See generally* BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 44.1 (3d ed. 1999 & Supp. III 2004); Karen C. Burke, *Disguised Sales Between Partners and Partnerships: Section 707 and the Forthcoming Regulations*, 63 IND. L.J. 489, 522–29 (1988); David R. Keyser, *A Theory of Nonrecognition Under an Income Tax: The Case of Partnership Formation*, 5 AM. J. TAX POL'Y 269, 279–85 (1986).

113. I.R.C. § 1031(a).

114. *Id.*

115. *Id.* § 1001.

116. This is true whether one thinks of the partnership as an aggregate of its partners or an entity separate and distinct from them. Under the aggregate view of partnerships, the distributee partner would be treated as if she relinquished her direct interest in each individual item of

fundamentally alters the nature of the partnership, closing a chapter for the historic partnership and opening a new chapter for the reconstituted partnership. From this vantage, the current law's nonrecognition rule fails to capture the substantive impact of liquidating distributions, treating them as continuations, rather than terminations, of a partner's investment in a partnership.

Of equal importance, property distributions mark the termination of the partnership's investment in the distributed property. If one thinks of the partnership as an entity separate from its partners, then the partnership itself is relinquishing its investment in property through the distribution. Likewise, if one disregards the partnership and thinks of the partners as direct co-owners of its property, then each partner would be treated as terminating her investment in her respective share of the distributed property.[117] Considered in this light, nonrecognition is again inappropriate, mischaracterizing the substance of the distribution transaction.[118]

2. The Ripple Effect

These theoretical gaps in the treatment of distributions have created practical challenges for subchapter K. Like all of the federal income tax, subchapter K is grounded in the notion that the tax consequences of a transaction should match the corresponding economic consequences.[119] When the tax treatment of a transaction deviates from this equitable notion, partnerships often behave opportunistically in pursuit of an improper tax advantage. The

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partnership property in the distribution. Under the entity view of partnerships, in contrast, the distributee partner would be treated as if she relinquished her interest in the partnership itself.

117. In this instance, however, the aggregate theory of partnerships raises a complication. If each partner were treated as if she directly owned her proportionate interest in each item of partnership property, then the distributee partner would already own a portion of the property that she receives in the liquidating distribution. To the extent of this portion of the distributed property, the liquidating distribution arguably has no effect, simply transferring property to the distributee partner that she already owns. Put another way, the distributee partner's investment is continuing, not terminating with respect to this portion of the distributed property. One might argue that nonrecognition is thus appropriate, at least for this portion of the larger transaction. This issue will be discussed *infra* note 157.

118. Indeed, the economic treatment of liquidating distributions, as evidenced by the partners' capital accounts, reflects the transformative effect of these transactions. As previously discussed, a distribution is treated as a recognition event for capital account purposes. *See supra* notes 41 and 45. Of equal importance, the partnership may elect to rebook all of its assets in connection with a distribution in partial or complete liquidation of a partner's partnership interest. *See supra* note 54.

119. *See supra* notes 21–27 and accompanying text.

government, in turn, is forced to respond with technical anti-abuse provisions. The result is discord in one of subchapter K's most ubiquitous transactions.

a. Complexity

The complexity of partnership distributions was perhaps inevitable, when considered in light of Congress's dual commitment to flexibility and equity. Reconciling these goals required a distinctive rulemaking design: one that was targeted, technical, and terribly intricate.[120] And this model is evident in the anti-abuse provisions that Congress layered into subchapter K's distribution system.[121]

Notwithstanding their shared design, these anti-abuse provisions are not homogenous. On the contrary, all of these provisions are independently complicated, and their complexities are distinctive. Congress individualized each provision in order to target a particular

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120. *See supra* notes 82–83 and accompanying text.

121. It is also evident in the elective provisions that overlay partnership distributions. As previously discussed, partnerships are permitted to rebook all of their assets for capital account purposes in connection with partial and complete liquidating distributions. *See supra* note 54. Additionally, subchapter K contains elective provisions designed to address basis mismatches created by partnership distributions. I.R.C. §§ 734(b), 754 (2006). These basis mismatches arise in two circumstances: (1) when the distributee partner recognizes a gain or a loss on a distribution; and (2) when the distributee partner takes a basis in the distributed property that differs from the partnership's pre-distribution basis in the property. In these instances, the partnership's basis in its remaining property, which is not ordinarily adjusted to reflect a distribution, no longer reflects the remaining partners' shares of pre-distribution built-in gain. *Id.* § 734(a). As a result, these partners will recognize too much or too little gain on the partnership's subsequent sale of its property. To ameliorate this problem, Congress permits partnerships to elect to adjust the basis of their remaining property following distributions that trigger these inequitable basis mismatches. *Id.* § 734(b). A partnership is permitted to increase the basis of its remaining assets if a partner recognizes a gain on a distribution or takes basis in the distributed property that is less than the partnership's pre-distribution basis in the property. *Id.* § 734(b)(1). Likewise, if a partner recognizes a loss on a distribution or takes a basis in the distributed property that is greater than the partnership's basis in the property, the partnership is permitted to decrease the basis of its remaining assets accordingly. *Id.* § 734(b)(2). Additionally, Congress mandates this type of negative basis adjustment when the distribution involves a substantial basis reduction. *Id.* § 734(b). If a distributee partner recognizes a loss in excess of $250,000 or the basis she takes in the distributed property exceeds the partnership's pre-distribution basis by more than $250,000, then the partnership is required to reduce the basis of its remaining property. *Id.* § 734(b), (d)(1). As noted, this treatment is elective in all other instances. *Id.* § 754. Once a partnership makes this election, however, it applies to all distributions, as well as certain sales of partnership interests. *Id.* For a more detailed discussion of these basis adjustments and their many challenges, see generally MCKEE ET AL., *supra* note 10, ¶ 24; WILLIS & POSTLEWAITE, *supra* note 54, ¶ 13.05; Howard Abrams, *The Section 734(b) Basis Adjustment Needs Repair*, 57 TAX LAW. 343 (2004); Andrews, *supra* note 7.

abuse without infringing on legitimate partnership distributions. To that end, these provisions all implement their recognition-based approach differently: some, like section 751(b), rely on a notional exchange between partner and partnership; and others, like the section 704(c)(1)(B) mixing bowl rule, rely on a hypothetical sale of partnership assets.[122]

Their operational mechanics also vary, with each provision using different statutory tools to combat a particular abuse. As previously discussed, section 751(b) is grounded in technical rules that require a partnership to navigate seven steps and three imaginary transactions in recasting a disproportionate distribution.[123] In contrast, the section 707(a)(2)(B) disguised sale rule relies on an open-textured standard to determine whether a contribution and distribution should be treated as a sale.[124] The section 737 mixing bowl rule follows a third approach, turning on specialized terminology, such as "net pre-contribution gain," to prevent income avoidance through a coordinated contribution and distribution.[125] These varied mechanics, in turn, ripple through each anti-abuse provision, often requiring customized basis adjustments and character rules at both the partner and partnership level.[126] Together,

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122. *See supra* notes 84–87 and accompanying text.

123. *See supra* note 10.

124. *See supra* note 82.

125. I.R.C. § 737(b). When section 737 applies to a distribution, the distributee partner is required to recognize gain in an amount equal to the lesser of (1) the partner's net pre-contribution gain and (2) the difference between the fair market value of the distributed property and the partner's outside basis immediately before the distribution. *Id.* § 737(a). A distributee partner's "net pre-contribution gain" is the amount of gain that the partner would recognize under section 704(c)(1)(B) if any property she contributed to the partnership in the preceding seven-year period were distributed to another partner. *Id.* § 737(b).

126. When a partner or partnership recognizes gain under any of these anti-abuse provisions, the character of this gain must be determined. To that end, many of these anti-abuse provisions include special provisions governing how such character determinations are to be made. *See, e.g.*, I.R.C. §§ 704(c)(1)(B)(ii) (character determined by a hypothetical sale), 737(a) (character determined by reference to proportionate character of the net pre-contribution gain); Treas. Reg. § 1.751-1(b)(2)(iii), (3)(ii) (character determined by reference to the character of the property relinquished in the exchange). Similarly, these recognized gains often trigger basis adjustments. *See, e.g.*, I.R.C. §§ 704(c)(1)(B)(iii) (basis adjustments to contributed property and contributing partner's outside basis), 737(c) (basis adjustments to contributed property and contributing partner's outside basis); Treas. Reg. § 1.731-2(f) (basis adjustment to marketable securities distributed to a partner). In addition, section 751(b) requires the partnership to make basis adjustments in connection with each of its three fictional transactions. Treas. Reg. § 1.751-1(b)(2), (3).

this operational diversity forms an additional layer of complexity for partnerships making distributions to their partners.

Even so, the most formidable aspect of subchapter K's distribution system is the system itself. The sheer number of provisions governing distributions is overwhelming to many, if not most, partnerships, especially when coupled with the provisions' individual complexities. Navigating this system thus requires time, energy, and resources, all of which are often scarce. Indeed, complexity has made it virtually impossible for increasing numbers of partnerships to understand and apply subchapter K's distribution system.

b. Inequity

One might willingly tolerate some complexity in subchapter K's distribution system if it effectively combated abusive transactions. Unfortunately, this has not been the case; partnership distributions remain inequitable, failing to tax partners based on their relative circumstances.

A principle source of the inequity in partnership distributions is the system's nonrecognition premise. Without the deferral that nonrecognition affords, much of the character conversion, income shifting, and income avoidance endemic to partnership distributions would not exist. Yet the anti-abuse provisions that Congress adopted to address these abuses have proven counterproductive, not achieving their equitable goals but contributing mightily to the legal complexity of partnership taxation.

Just as design contributed to the distribution system's complexity, it also contributed to its inequity. As previously discussed, Congress narrowly tailored subchapter K's anti-abuse provisions in order to target particular tax shelters without impeding legitimate partnership transactions.[127] For example, many of these anti-abuse provisions apply for a finite number of years: two in the case of the section 707(a)(2)(B) disguised sale rule; and seven in the case of the section 704(c)(1)(B) and 737 mixing bowl rules.[128]

127. *See supra* Part II.C.1.

128. I.R.C. §§ 704(c)(1)(B) (applies when property is contributed to the partnership and then distributed to another partner within the following seven-year period), 737(a)–(b) (applies when property is distributed to a partner that contributed property to the partnership during the seven-year period preceding the distribution); Treas. Reg. § 1.707-3(c)(1), (d) (1992) (rebuttable presumptions that (1) a contribution and a distribution to the same partner that occur within a

Similarly, some anti-abuse provisions only apply once a distribution exceeds a specified monetary threshold.[129] In both instances, however, these statutory limitations impair the overall efficacy of subchapter K's efforts to prevent abusive distributions. Transactions structured outside these limitations continue unaffected, and partnerships are perhaps even emboldened by the expressive function of government line drawing.

Of equal importance, many of these anti-abuse provisions are technically flawed. Section 751(b), for example, is replete with such flaws. In fairness, this was probably inevitable, as no single provision could be expected to combat all the abuses made possible by nonrecognition. Yet section 751(b)'s technical defects make it a particularly ill-suited defender of equity in partnership distributions.[130] Partnership tax scholars have thus dedicated countless hours and pages to cataloguing section 751(b)'s flaws.[131] I do not propose to recount the entire bill of particulars, but one

two-year period are a disguised sale and (2) a contribution and a distribution to same partner that do not occur within a two-year period are not a disguised sale).

129. For instance, section 751(b)'s definition of "hot assets" only includes inventory, as defined in section 751(d), if it is substantially appreciated. I.R.C. § 751(b)(3)(A) (inventory will be considered "substantially appreciated" if its aggregate fair market value exceeds 120 percent of its aggregate basis); *see also id.* § 734(b), (d)(1) (requiring mandatory basis adjustment when the distributee partner recognizes a loss in excess of $250,000 or the partner's basis in the distributed property exceeds the partnership's pre-distribution basis in the property by more than $250,000).

130. Put another way, section 751(b), as currently drafted, does not succeed in preventing the abuses it was designed to combat. Nonetheless, the theory underlying section 751(b)—that liquidating distributions are taxable exchanges—is sound. Indeed, as will be discussed *infra* Part III.B, it may be the most sound aspect of subchapter K's distribution regime.

131. *See, e.g.*, AM. BAR ASS'N SECTION OF TAXATION, COMMENTS CONCERNING NOTICE 2006-14, *reprinted in* 2007 TAX NOTES TODAY 82-22 (Apr. 25, 2007); Andrews, *supra* note 7, at 45–55; Burke, *supra* note 11, at 680–86; Noël B. Cunnngham, *Needed Reform: Tending the Sick Rose*, 47 TAX LAW REV. 77, 89–104 (1991); N.Y. STATE BAR ASS'N TAX SECTION, REPORT RESPONDING TO NOTICE 2006-14 RELATING TO THE TREATMENT OF PARTNERSHIP DISTRIBUTIONS UNDER SECTION 751(B), *reprinted in* 2006 TAX NOTES TODAY 230-8 (Nov. 28, 2006); Yin, *supra* note 5, at 233–38. A sampling of section 751(b)'s many technical flaws, as identified by these scholars, includes: (1) the definition of "hot asset"; (2) the "substantial appreciation" requirement for inventory; (3) the failure to extend section 751(b) treatment to depreciable assets; (4) the use of an exchange model, rather than a sale model, in determining the tax consequences of a disproportionate distribution; (5) the need to identify the assets hypothetically distributed to the partner in anticipation of the deemed exchange; and (6) the use of gross asset value to determine whether a distribution is disproportionate, which will be discussed herein. *Id.* As discussed *supra* note 89, the Treasury is considering its options for reforming section 751(b). I.R.S. Notice 2006-14, 2006-1 C.B. 498. In particular, it has requested comments on revisions designed to improve the regulation's method of determining whether a distribution is disproportionate and to streamline the tax consequences associated with a recharacterized distribution. *Id.* § 3.

example might prove useful in illustrating how section 751(b) is its own worst enemy.

Section 751(b)'s triggering mechanism is a perfect example of these flaws. As previously discussed, section 751(b) applies when a distributee partner receives a disproportionate share of a partnership's ordinary, or hot, assets.[132] To this end, each partner's share of the partnership's hot assets is determined based on gross asset value.[133] If a partner holding a one-third partnership interest receives a distribution in complete liquidation of her partnership interest, she must receive one-third of the partnership's hot assets, as determined by reference to their fair market value, in the distribution. If she does not, the distribution will trigger section 751(b).

To illustrate, let's return to the *ABC* equal partnership. This time, however, let's assume that the partnership holds three assets—Blueacre, Inventory #1, and Inventory #2. *C* wishes to retire from the partnership and, at this time, the partnership has the following balance sheet:

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Inventory #1	100	100	A	150	200
Inventory #2	50	200	B	150	200
Blueacre	300	300	C	150	200
Total	450	600		450	600

To accommodate *C*'s decision, the partnership distributes a portion of Blueacre with a fair market value of $100 and Inventory #1 to *C* in complete liquidation of her partnership interest. Under section 751(b)'s triggering mechanism, this distribution would not be considered disproportionate. Before the distribution, the partnership's hot assets were worth $300, and the partners shared this

132. *See supra* notes 92 and accompanying text.
133. Treas. Reg. § 1.751-1(g), exs. 2, 3.

aggregate hot asset value equally, $100 each.[134] *C* received Inventory #1 in the distribution when its fair market value was $100. She would thus have received exactly her share of the partnership's hot assets, as determined by their gross asset value, in the transaction, hence avoiding the section 751(b) disproportionate distribution rule.[135]

Herein lies a problem. This distribution would be abusive, converting the character of *C*'s built-in gain from ordinary to capital and shifting income among the partners. Prior to the distribution, there was a $150 built-in gain in Inventory #2; if the partnership had sold the property, it would have recognized a $150 ordinary gain.[136] In turn, each partner's share of this ordinary gain would have been $50.[137] Inventory #1, in contrast, had no built-in gain because its fair market value equaled its basis.

The distribution in complete liquidation of *C*'s interest would change these shares, yet section 751(b) would treat the transaction as a proportionate distribution, failing to respond to the resulting inequities. Consider the tax consequences to *C*. She would not recognize a gain on the distribution; instead her $50 built-in gain would be preserved for future recognition on a sale of Blueacre.[138] In determining *C*'s basis in the distributed property, the partnership would begin with her pre-distribution outside basis of $150, which it would allocate between Blueacre and Inventory #1.[139] As previously

134. The partnership holds two hot assets—Inventory #1 and Inventory #2—with a total fair market value of $300 ($100 fair market value of Inventory #1 plus $200 fair market value of Inventory #2). As a one-third partner in the partnership, each partner's share of this aggregate fair market value is $100 ($300 aggregate fair market value of hot assets * 1/3).

135. Similarly, *C* would have received exactly her share of cold assets. Before the distribution, Blueacre was worth $300, and each partner shared this value equally, $100 each. *C* then receives a portion of Blueacre with a fair market value of $100.

136. At the time of distribution, Inventory #2 had a fair market value of $200 and a basis of $50.

137. As one-third partners, each partner's share of this recognized gain would have been $50 ($150 * 1/3).

138. I.R.C. § 731(a)(1) (2006).

139. *Id.* § 732(b), (c). In a complete liquidating distribution, the distributee partner's basis in the distributed property equals her pre-distribution outside basis less the amount of cash received in the distribution. *Id.* § 732(b). If the partner's outside basis is not sufficient to allow her to take a basis in each item of distributed property equal to the partnership's pre-distribution basis in the property, then her post-distribution basis in the distributed property must be reduced. Section 732(c), which provides the rules governing the allocation of this basis reduction among the distributed property, requires a partnership to first allocate basis to any distributed hot assets. *Id.* § 732(c)(1)(A)(i). Any outside basis remaining after this priority allocation is then allocated to the distributed cold assets. *Id.* § 732(c)(1)(B).

discussed, this basis allocation is achieved through a statutory basis adjustment.[140] Under these provisions, hot assets receive a priority allocation of basis; hence, *C* would take a $100 basis in Inventory #1, which equals the partnership's basis in the property.[141] *C*'s remaining outside basis of $50 would then be allocated to Blueacre, which has a $100 fair market value at the time of distribution.[142] If *C* were to sell Blueacre following the distribution, she would recognize a $50 capital gain, thereby effecting an improper character conversion. Indeed, the distribution would have resulted in precisely the type of character conversion that section 751(b) was designed to prevent.

Likewise, the distribution would produce inequitable results for the remaining partners, *A* and *B*. After the distribution, the partnership would have the following balance sheet:

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Inventory	50	200	A	150	200
Blueacre	200	200	B	150	200
Total	250	400		300	400

The distribution would increase their respective shares of Inventory #2's built-in gain by $25, from $50 to $75. If the partnership were to sell Inventory #2 after the distribution, it would recognize a gain of $150 and allocate it equally between *A* and *B*, $75 each. In doing so, the distribution would have improperly shifted $25 of Inventory #2's pre-distribution built-in gain to each of the remaining partners.[143]

140. *Id.* § 732(b); *see supra* note 53 and accompanying text.
141. *Id.* § 732(c)(1)(A)(i).
142. *Id.* § 732(c)(1)(B).
143. As previously discussed, this shift is only temporary; it will reverse itself when the partners sell or liquidate their respective partnership interests. *See* Andrews, *supra* note 63. Likewise, this is a situation that would trigger a basis adjustment under section 734(b) if the partnership had made the proper election. I.R.C. §§ 734(b), 754. This elective basis adjustment would allow the partnership to adjust its basis in the remainder of Blueacre to reflect the $50 of basis "lost" in the distribution to *C*. *Id.* § 734(b)(1)(B). Section 734(b), even if elected by the partnership, is an imperfect fix to this problem. Although it prevents the income shift, it fails to address the character conversion. If the partnership were to make a basis adjustment, it would

The culprit is section 751(b)'s triggering mechanism, which relies on gross asset value to determine whether a distribution is disproportionate. Value, as can be seen in the previous example, is the wrong measure of disproportionality because it fails to capture the distributions that section 751(b) was enacted to combat—distributions that alter the amount or character of a partner's share of the partnership's pre-distribution built-in gain. A triggering mechanism proceeding from built-in gain, one that requires an examination of the relationship between a property's value and its basis, would better align section 751(b) with its equitable goals. Despite repeated efforts to reform section 751(b)'s triggering rule, it remains grounded in gross asset value.[144] And section 751(b) thus remains counterproductive, allowing partnerships to alter the amount and character of their partners' shares of pre-distribution built-in gain in violation of equitable norms.

Of equal importance, subchapter K's distribution system also compromises vertical equity.[145] Modern partnerships are immensely polarized, with sophisticated, well-advised partnerships pursuing tax shelters at one extreme, and simple, commercially focused partnerships at the other extreme. In large part, subchapter K's distribution system evolved in response to the small number of partnerships engaged in abusive transactions. Yet its complicated provisions apply to all partnerships, whether big, small,

increase the basis of Blueacre by $50, from $200 to $250. *Id.*; Treas. Reg. § 1.755-1(c)(1)(i). In doing so, the basis adjustment would create a $50 built-in capital loss in Blueacre, which *A* and *B* would share equally, $25 each. Thus, each remaining partner would have a net built-in gain of $50—a $25 built-in capital loss attributable to Blueacre and a $75 built-in ordinary gain attributable to Inventory #2. Even though their net built-in gains would remain unchanged, *A* and *B* may still be worse off in this situation due the limitations on capital losses. I.R.C. § 1211(b).

144. *See, e.g.*, MCKEE ET AL., *supra* note 10, ¶ 21.01[2]; Andrews, *supra* note 7, at 48–49; Burke, *supra* note 11, at 685; Gergen, *supra* note 30, at 353–54. As discussed *supra* note 131, the Treasury is considering an alternative method of determining whether a distribution is disproportionate. I.R.S. Notice 2006-14, 2006-1 C.B. 498. More specifically, the Treasury has requested comments on the "hypothetical sale approach" to the disproportionality determination. *Id.* Under this approach, a partnership would compare the amount of ordinary income that would be recognized by its partners if it sold all of its hot assets, including any hot asset distributed to its partners, for their fair market value immediately before and immediately after the distribution at issue. *Id.* A distribution would be disproportionate if any partner's allocated share of ordinary income decreased as a result of the distribution. *Id.* Additionally, the partnership would be required to take into account section 704(c) principles, namely a revaluation of the partnership's property, in making this determination. *Id.* In doing so, it is hoped that a significantly smaller number of distributions would trigger section 751(b).

145. *See* WITTE, *supra* note 15.

sophisticated, or simple.[146] Everyday partnerships, which share little in common with sheltering partnerships, thus bear a disproportionate burden, financial and otherwise, for the abusive behavior of a minority of partnerships.

c. Instability

Throughout the past half-century, subchapter K's distribution system has become a technical minefield with few guides for partnerships attempting to navigate its provisions. The system lacks the unifying ties necessary to foster stability in partnership distributions. The result is incoherence; partnerships often do not know what the law of distributions is.

Consider the average partnership making a distribution to one of its partners. This partnership might know, as a general matter, that a distribution is a nonrecognition event; thus, the partnership may expect that neither it nor the distributee partner will recognize gain on the transaction. Imagine this partnership's dismay at learning that subchapter K's general nonrecognition rule is subject to at least four separate anti-abuse provisions, any of which might require gain recognition.[147] Further, each of these provisions operates differently, requiring the partnership to work through four triggers and four computational analyses in determining the tax consequences of this one distribution.[148] Perhaps more surprising, some of these anti-abuse provisions may require gain recognition by the non-distributee partners as well, who receive nothing in the distribution.[149]

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146. *See, e.g.*, Lawrence Lokken, *As the World of Partnership Taxation Turns*, 56 SMU L. REV. 365, 367 (2003) ("The revolutionary accretion of detail in subchapter K is largely a response to aggressive uses of partnerships for tax avoidance . . . The dilemma of subchapter K is that rules considered essential to the effective application of the tax laws to some partnerships and their partners apply to all partnerships, including those utterly lacking in capability to apply the rules, which likely comprise a large majority of all partnerships."); Yin, *supra* note 5, at 191 ("Although larger businesses would also benefit from simplification, they might have alternative means not available to smaller businesses of coping with tax law complexity.").

147. Even the Service recognizes this inconsistency between the commercial expectations of many partners and the current state of subchapter K's distribution system: "Although the general rule aims to treat partnership distributions as nontaxable events, the exceptions can quickly overshadow the general rule." INTERNAL REVENUE SERV., PARTNERSHIP–AUDIT TECHNIQUE GUIDE CH. 4 (2007).

148. *See supra* notes 122–26 and accompanying text.

149. I.R.C. §§ 707(a)(2)(B), 751(b) (2006). With respect to section 751(b), the Treasury is considering an alternative to current law's exchange method of determining the tax consequences of a triggering distribution. I.R.S. Notice 2006-14, 2006-1 C.B. 498. Under the proposed "hot asset sale approach," a disproportionate distribution would be recast as a two-step transaction: (1)

Subchapter K's distribution system is indeed tangled, often running contrary to partnerships' expectations. Considered in this light, it is no wonder that so many partnerships struggle to understand and apply the law of partnership distributions.

3. The Compliance Crisis

The true cost of this dysfunctionality is reflected in declining compliance across the partnership spectrum. Distributions are a minefield for the average partnership, with traps for the unwary at every turn. The complexity and cost of accessing this discordant system have made full compliance virtually impossible for many, if not most, partnerships. Consider, for instance, this description of section 751(b):

> [Section 751(b)'s] application is not recognized in [ninety] percent of the cases to which it applies . . . In half the cases in which its applicability is recognized, the other remaining [ten] percent, it is ignored because the cost of complying is far greater than any revenue gain, and in, I would say, half of the remaining [five] percent, when people including the Internal Revenue Service, attempt to apply it, they do so incorrectly.[150]

Well-intentioned partnerships are thus left with few good options. They can try to run subchapter K's gauntlet, taking the risk of falling

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a distribution of the partner's share of the relinquished hot assets; and (2) a subsequent taxable sale of the hot assets back to the partnership immediately before the actual distribution. *Id.* Unlike current law, the partner relinquishing a share of the partnership's cold assets would no longer recognize gain on the disproportionate distribution. Numerous commentators have proposed "tweaks" to this hot asset sale approach, all of which are designed to produce comparable results with less complexity. *See, e.g.*, AM. BAR ASS'N SECTION OF TAXATION, *supra* note 131, at 24–25; N.Y. STATE BAR ASS'N TAX SECTION, *supra* note 131, at 37–50; Karen C. Burke, *Remedying Flaws in the Hot Asset Sale Approach*, 116 TAX NOTES 279 (2007).

150. *Issues Relating to Passthrough Entities*: *Hearings Before the Subcomm. on Select Revenue Measures of the U.S. H. Comm. on Ways & Means*, 99th Cong. 56 (1986) (statement of Joel Rabinovitz). Mr. Rabinovitz is not alone in his assessment of section 751(b). *See, e.g.*, AM. LAW INST. SUBCHAPTER K PROJECT, *supra* note 11, at 51 ("If the reports of noncompliance with Section 751(b) are correct, the continuance of such a provision must have an adverse bearing on taxpayer respect for the law."); Berger, *supra* note 11, at 147 (describing section 751(b) as one "of subchapter K's least understood and most widely ignored provisions"); Eustice, *supra* note 11, at 383 ("Section 751(b) is difficult to understand and complex in operation, and as a consequence it is probably largely unenforced. It may be the Achilles heel of subchapter K."); Hanna, *supra* note 11, at 524 ("The almost unanimous consensus has been that section 751(b) should never have been enacted or, at the very least, should have been repealed years ago."); Lokken, *supra* note 5, at 277 (describing subchapter K's distribution system as "one of the principle repositories of unworkable complexity" in partnership taxation).

into one of its many distribution-related traps. Or, they can forego technical compliance and instead follow what scholars call an "intuitive subchapter K," doing the best they can with available resources and hoping to escape the attention of the Internal Revenue Service ("Service").[151] In either case, the result is troublesome—subchapter K's distribution system appears to be honored largely in the breach.[152]

In contrast, distributions continue to be a treasure trove for the small number of partnerships pursuing tax shelters. Subchapter K's complicated anti-abuse provisions are often incomplete, leaving gaps for tax shelters and offering roadmaps for future abusive transactions. Further, sheltering partnerships benefit from the noncompliance of nonsheltering partnerships, which shields their abuse from detection by the Service. Indeed, these partnerships capitalize on the struggles of the average partnership by using the overall dysfunctionality of partnership distributions to their financial advantage.

When compliance falters, the public cost is significant. Tax revenues suffer, and partners question the fairness of the distribution system and subchapter K, more generally. A vicious cycle emerges where noncompliance, public illegitimacy, and discord reinforce one another. The resulting instability breeds frustration among partners who, in turn, are more inclined to perceive subchapter K as corrupt.

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151. Lokken, *supra* note 146, at 367 ("[W]e already have a K lite, consisting of the present subchapter K stripped of all the rules and nuances that tax practitioners serving ordinary partnerships do not understand and simply ignore."); Lokken, *supra* note 5, at 252 ("A large number of partnerships thus seem to be governed by what might be called an 'intuitive subchapter K.' Taxpayers and tax advisers who want to comply account for partnership transactions in ways that are consistent with their conceptions of the basic aims of subchapter K."); Yin, *supra* note 5, at 201 ("[I]t may well be that many small firms . . . already utilize a watered-down, intuitive version of subchapter K.").

One might wonder why an intuitive subchapter K is problematic, especially if most partnerships can approximate the right result without incurring the expense of navigating subchapter K's complexity. *See* Philip F. Postlewaite, *I Come to Bury Subchapter K, Not to Praise It*, 54 TAX LAW. 451, 473 (2001). Ultimately, this is an empirical question, and the answer depends on how "close" the results are under an intuitive subchapter K. Yet the empirical work necessary to analyze this claim regarding partner compliance has not been done, and the substantive work of reforming partnership taxation must proceed. Thus, we must proceed provisionally using reasonable working assumptions about partnership compliance. To that end, this Article assumes that non-sheltering partnerships want to follow the law and, thus, a system where large numbers of partnerships are excluded from the possibility of "perfect" compliance is problematic.

152. Lokken, *supra* note 146, at 365–66; Yin, *supra* note 5, at 235.

These partners are thus more likely to engage in abusive distributions, which often provoke counterproductive responses from the government, further entrenching complexity, inequity, and instability in partnership distributions.

E. The Problem of Nonrecognition

Partnership distributions are deeply flawed, with challenges almost too numerous to count. Subchapter K's complicated distribution provisions, their relationship to one another, and their impact on partnership taxation as a whole are entirely dysfunctional. Calls for reforming or repealing subchapter K's most troublesome provisions, particularly section 751(b), thus began shortly after codification in 1954 and continue to this day.[153]

Yet these calls misconstrue the problem posed by partnership distributions. Section 751(b) is not the problem; nor are any of subchapter K's individual provisions, despite their many flaws.

153. *See supra* note 11. In 1999, the Clinton Administration proposed repealing section 751(b) as part of a larger, coordinated reform of partnership distributions. DEP'T OF THE TREASURY, GENERAL EXPLANATION OF THE ADMINISTRATION'S REVENUE PROPOSALS 134 (1999), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2000.pdf; STAFF OF THE JOINT COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2000 BUDGET PROPOSAL 237 (Comm. Print 1999), *available at* https://www.jct.gov/publications.html?func=startdown&id=1225. Despite this laudable effort at comprehensive distribution reform, the Clinton Administration's proposals were not well received by many members of the partnership tax community. *See, e.g.*, Ernst & Young LLP, *Analysis of the Administration's Partnership Proposals*, 84 TAX NOTES 103 (1999); Barton Massey, *McKee Blasts Administration's Tax Shelter/Partnership Proposals*, 1999 TAX NOTES TODAY 48-8 (Mar. 12, 1999). *But see* Karen C. Burke, *Reassessing the Administration's Proposals for Reform of Subchapter K*, 86 TAX NOTES 1423 (2000). Recently, Representative Dave Camp, Chairman of the Committee on Ways and Means, released a discussion draft targeted at pass-through tax reform. H. COMM. ON WAYS AND MEANS, TECHNICAL EXPLANATION OF THE WAYS AND MEANS COMMITTEE DISCUSSION DRAFT PROVISIONS TO REFORM THE TAXATION OF SMALL BUSINESS AND PASSTHROUGH ENTITIES (2013), *available at* http://waysandmeans.house.gov/uploadedfiles/final_sm_bus_passthrough_technical_explanation_03_12_13.pdf [hereinafter, COMM. ON WAYS AND MEANS, 2013 PASSTHROUGH DISCUSSION DRAFT]; *see also* Karen C. Burke, *Pass-Through Entities: The Missing Element in Business Tax Reform*, 40 PEPP. L. REV. 1329 (2013); George K. Yin, *Comments on Selected Draft Reforms of the House Committee on Ways & Means on the Taxation of Passthrough Entities*, 140 TAX NOTES 358 (2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2275324; Williard B. Taylor, *Should There Be One Set of Passthrough Rules for All Non-Publicly Traded* Businesses? (Option 2 of the Ways and Means Committee Draft to Reform the Taxation of Small Business and Passthrough Entities) (Oct. 22, 2013) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2343776. Representative Camp's discussion draft offers two options for the reform of subchapter K and S. Interestingly, both proposals retain section 751(b), expanding its scope to treat all inventory, rather than just substantially appreciated inventory, as hot assets. *Id.* at 30–31, 57.

Nonrecognition—the central premise of subchapter K's distribution system—is the problem. Fixing partnership distributions thus requires fixing nonrecognition, not the anti-abuse provisions designed to combat particular transactions that exploit subchapter K's liberal distribution system. Indeed, a continued focus on these anti-abuse provisions only exacerbates the problem with partnership distributions, perpetuating the vicious cycle that is rooted in the system's core nonrecognition premise.

If recognition were instead the rule, partnerships would no longer be able to defer built-in gains; hence, distributions would no longer create opportunities for partnerships to convert character, shift income, or avoid the recognition of gain. In turn, there would be no need for so many intricate anti-abuse provisions to prevent improper distributions. Partnership distributions would thus look very different than they do today: simpler, more equitable, and more stable.

The time has come to rethink partnership distributions, beginning with the nonrecognition premise at the system's foundation. An alternative vision of partnership distributions, one without the imprint of nonrecognition, is needed.

III. RETHINKING PARTNERSHIP DISTRIBUTIONS

This Article takes first steps toward greater functionality and harmony in partnership distributions, reimagining these transactions from a recognition-based perspective. In describing the challenge of designing a viable system of taxing distributions before subchapter K's codification, one scholar noted that:

> It is a pleasant bit of mental gymnastics to criticize the patchwork system that has developed, and to demand with righteous indignation that the Treasury and the courts cooperate in a coherent and consistent matter of taxation. It is a grimmer job, however, to formulate a set of rules which will be consistent in theory, equitable in effect, and simple in practice. The dilemma is nicely illustrated by one fundamental problem, that of distributions in kind to a partner. The challenge is to draft a statute which will extricate taxpayer and Government from their present difficulties, by neatly correlating the answers in terms of partnership gain, or loss, partnership basis, partners' gains

> or losses, and partners' bases. It should be possible—or so one would think.[154]

These words are equally true today, sixty years later. Rethinking distributions is a daunting task, but it is one that can no longer be ignored.

In rethinking distributions, I draw inspiration from an unlikely source—the disproportionate distribution rule of section 751(b). Contrary to conventional wisdom, section 751(b) got the theory of partnership distributions right, treating liquidating distributions as taxable exchanges. When considered in this light, section 751(b)'s principal flaw is not its complexity, or even its inability to prevent abuse. Rather, it is the provision's failure to treat all liquidating distributions as recognition events. Expanding recognition may thus hold the solution to the seemingly intractable problem of partnership distributions.

This Article thus proposes dividing distributions into two categories—operating distributions and liquidating distributions—in order to rationalize their treatment. Operating distributions would continue to be treated as preemptively tax-free transactions in which the distribution itself has no impact on the relationship among the partners. Liquidating distributions, however, would be treated as taxable exchanges between the partnership and the distributee partner.

I do not mean to suggest that a recognition-based approach to distributions is perfect, or perfectly simple. It is neither. But a recognition-based approach would align the tax treatment of liquidating distributions with their commercial substance, recognizing these transactions' economically transformative effect on partnerships and their partners. In so doing, this proposal would offer a simpler, more equitable, and more stable system of taxing distributions. A recognition rule would create a pathway to a more coherent subchapter K, one that would be more accessible to the many partnerships that are struggling, and often failing, to navigate the current law.

154. Mark H. Johnson, *Notes: Property Distributions by Partners*, 4 TAX L. REV. 118, 118 (1948) (footnotes omitted).

A. Recognition-Based Distributions

In reimagining partnership distributions, I propose two foundational changes to subchapter K: redefining distributions and reformulating their tax consequences. Simplification should be a priority, with provisions that are accessible to partnerships at all levels of wealth and sophistication. Likewise, a reformed distribution system should prioritize equity. Partnership distributions should not alter the amount or character of any partner's share of the partnership's pre-distribution built-in gain. If the partnership cannot preserve these amounts for future recognition by the appropriate partner, then such partner should recognize gain at the time of distribution. A greater focus on simplicity and equity, in turn, would foster stability in the tax treatment of distributions, providing partnerships with a coherent guide through subchapter K's distribution system.

1. Property Distributions

Reforming partnership distributions begins with economic reality. A starting point in this project is thus the tax treatment of property distributions. In these transactions, a partnership terminates its investment in the distributed property, potentially altering the amount and character of each partner's share of the property's built-in gain. Considered in this light, treating property distributions as taxable transactions in all instances is appropriate; it would better match the tax consequences of these distributions with their commercial reality.[155]

Under this proposal, a partnership would recognize gain on the distribution of appreciated property.[156] The partnership would

155. This proposal would align the partnership-level treatment of property distributions with the treatment of property distributions by C corporations and S corporations. I.R.C. §§ 311(b), 336(a), 1371(a) (as amended in 2006). Under these provisions, a corporation recognizes gain on the distribution of appreciated property in all instances. *Id.* § 311(b). Losses, in contrast, are only recognized when property is distributed in complete liquidation of the corporation. *Id.* § 336(a). This approach also mirrors the current capital account treatment of property distributions, which requires a partnership to recognize any economic gains and losses in the distributed property before it is transferred to the distributee partner. Treas. Reg. § 1.704-1(b)(2)(iv)(e)(1) (2013).

156. Taxing property distributions at the partnership level, standing alone, would represent an important step forward in rationalizing the tax treatment of partnership distributions. It thus could be severed from the remainder of this Article's proposal. Indeed, numerous scholars have proposed taxing property distributions in this manner as part of larger reform projects. *See, e.g.*, Berger, *supra* note 11, at 154; Eustice, *supra* note 11, at 383–84; Gergen, *supra* note 11, at 220–23; Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229, 258–

compute the amount and character of this gain based on a hypothetical sale of the distributed property at its fair market value immediately before the distribution. The partnership would then allocate the recognized gain among all its partners, including the distributee partner, according to their pre-distribution sharing arrangement.[157] Each partner would increase her outside basis accordingly to reflect her share of this recognized gain, and the basis of the distributed property would be similarly increased.

To illustrate, let's return to the *ABC* partnership. This time, let's assume that the partnership has three assets: cash, inventory, and a new investment property ("Orangeacre"). Imagine that the partnership distributes Orangeacre to *C* in partial liquidation of her partnership interest. Immediately before the distribution, the partnership has the following balance sheet:

61 (1998); Lokken, *supra* note 5, at 277; Postlewaite et al., *supra* note 11, at 604, 606–07; Yin, *supra* note 5, at 229. In addition, the House Ways and Means Committee recently issued a discussion draft of provisions designed to reform the taxation of pass-through entities. *See* COMM. ON WAYS AND MEANS, 2013 PASSTHROUGH DISCUSSION DRAFT, *supra* note 153. Under its uniform proposal for the taxation of pass-through entities, pass-through entities would recognize gain, but not loss, on the distribution of property to their owners. *Id.* at 50–51.

157. As previously discussed, *supra* note 117, one might argue that taxing the distributee partner on her share of the distributed property's gain would be inappropriate. *See* Burke, *supra* note 11, at 698. To the extent that the distributee partner is treated as directly owning her share of the distributed property, the liquidating distribution would have little effect, simply transferring property to the distributee partner that, under the aggregate theory of partnerships, she would already be treated as owning. When considered in this light, the distributee partner would be overtaxed if she were required to recognize gain attributable to this portion of the distributed property. *Id.*

Consistent with the aggregate theory of partnerships, one could address this problem through a hybrid recognition/nonrecognition approach. The distributee partner would not recognize her share of the gain on the transfer of the distributed property. This share of built-in gain would be deferred, instead recognized by the distributee partner in the future when she sells the distributed property. In order to implement this approach, a basis adjustment provision would be necessary, requiring the distributee partner to take a basis in the distributed property that reflects the amount of pre-distribution built-in gain deferred on the distribution. Although perhaps a more technically "pure" approach to partnership distributions, I have decided against this hybrid approach because of the additional complexity that it would introduce into a reformed distribution system.

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Cash	400	400	A	160	200
Inventory	10	100	B	160	200
Orangeacre	70	100	C	160	200
Total	480	600		480	600

At the partnership level, the distribution would be treated as a fully taxable transaction, and the partnership would recognize Orangeacre's $30 built-in gain. If the partnership had sold Orangeacre for its fair market value of $100 rather than distributing the property to *C*, it would have recognized a $30 capital gain.[158] Each partner would thus recognize a $10 capital gain in connection with Orangeacre's distribution and increase her outside basis accordingly, from $160 to $170.[159] The partnership, in turn, would increase its basis in Orangeacre by $30, from $70 to $100.

At this point, the partnership would have the following balance sheet:

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Cash	400	400	A	170	200
Inventory	10	100	B	170	200
Orangeacre	100	100	C	170	200
Total	510	600		510	600

158. Orangeacre had a fair market value of $100 immediately before the distribution, and its basis was $70. Thus, the partnership's sale of the property would have resulted in a recognized gain of $30. I.R.C. § 1001. Because the partnership held Orangeacre as investment property, this $30 gain would have been a capital gain. *Id.* § 1221(a).

159. *Id.* §§ 704(b), 705(a)(1)(A).

Each partner would thus be taxed on her share of Orangeacre's built-in gain. Consistent with equitable norms, the distribution would not alter the amount or character of any partner's share of this gain.[160]

2. Redefining Partnership Distributions

At the partner-level, the tax treatment of partnership distributions should reflect the commercial substance of these common, but diverse, transactions. This proposal thus begins with the premise that operating distributions and liquidating distributions are fundamentally different transactions. Operating distributions are largely invisible; they do not affect the partners' relationship to the partnership, its property, or its profits. Considered in this light, the current law's general nonrecognition rule is well suited to this type of distribution.[161] Liquidating distributions, in contrast, involve an economic transformation of the partnership, with a partner terminating her investment in the enterprise in whole or in part. Accordingly, treating these distributions as taxable exchanges between the partner and the partnership is more appropriate.

To implement this reformed distribution system, it is necessary to define operating distributions and liquidating distributions. Under this proposal, operating distributions would typically involve ratable distributions. These distributions do not alter the partners' respective interests in the partnership; hence, they would remain largely tax-free transactions.[162] Liquidating distributions, in contrast, would include all distributions where a partner terminates any portion of her investment in the partnership. In doing so, all distributions, whether

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160. The tax consequences of the distribution to *C*, the distributee partner, will be discussed *infra* Part III.A.3.

161. This Article, however, does propose several changes to the general nonrecognition treatment of partnership distributions, all narrowing the parameters of the current law's nonrecognition rule. The primary changes involve the partnership's recognition of gain on any distribution of property. *See supra* Part III.A.1. The remaining changes will be discussed *infra* note 162 and accompanying text.

162. As a general matter, a partner would not recognize gain on the receipt of an operating distribution. Rather, she would reduce her outside basis by the amount of cash received or the basis she takes in any distributed property. There would, however, be one exception to this rule: if the cash or the fair market value of any distributed property exceeds the distributee partner's outside basis, then she would recognize a gain equal to such excess. Similarly, this proposal would require the partnership to make a corresponding adjustment to the basis of its remaining property in order reflect the gain recognized by the distributee partner. In doing so, subchapter K's distribution system would ensure that each partner's share of the partnership's pre-distribution built-in gains are properly preserved.

complete or partial, that affect the amount or character of a partner's share of the partnership's pre-distribution built-in gain would be treated as liquidating distributions and subject to the recognition-based treatment proposed herein.[163]

At the extremes, distinguishing operating distributions and liquidating distributions is relatively straight forward: ratable distributions are operating distributions and distributions in complete liquidation of a partner's partnership interest are liquidating distributions. But identifying partial liquidating distributions presents a greater challenge, one requiring additional guidance as to the proper treatment of non-ratable distributions. As previously discussed, economic reality is the driver of this recognition-based approach to distributions. To that end, this proposal would treat a non-ratable distribution as a liquidating distribution if it alters the amount or character of a partner's share of pre-distribution partnership built-in gain, as reflected in the partners' sharing arrangement.[164] Accordingly, changes in the partners' method of sharing partnership profits, particularly gains derived from the disposition of its property, would be central to defining partial liquidating distributions.[165]

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163. *See infra* Part III.A.3.

164. This is currently the trigger for a revaluation of the partnership's property. Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(ii) (2013). Under this provision, a partnership may elect to revalue its asset in connection with a distribution of money or property "by the partnership to a retiring or continuing partner as consideration for an interest in the partnership." *Id.*

165. In proposing a recognition-based approach to liquidating distributions, one scholar would require the partners to enter into various agreements designed to memorialize the change in each partner's interest in the partnership. Postlewaite et al., *supra* note 11, at 598–99. Under this proposal, the partners would be required to execute the following agreements within thirty days of any liquidating distribution: (1) an allocation agreement, specifying the fair market value of all of the partnership's property; and (2) a sales agreement, specifying the partnership interest to be sold and its selling price. *Id.* at 599. Other scholars have proposed alternative means of identifying and quantifying partial liquidating distributions. One method focuses on the proportionate reduction in a partner's partnership interest. *See* AM. LAW INST., MEMORANDUM NO. 3, *supra* note 11, at 37–40. This proportionate reduction method relies on a mathematical formula to distinguish ratable distributions from non-ratable partial liquidating distributions. *See* AM. LAW INST., MEMORANDUM NO. 3, *supra* note 11, at 40 (adopting the formula (1 − b/a) / (1 − b), where "a" equals the distributee partner's pre-distribution interest in the entity and "b" equals her post-distribution interest in the entity). Another method focuses on the relative value of the distribution. *See, e.g.*, STAFF OF THE JOINT COMM. ON TAXATION, REVIEW OF SELECTED ENTITY CLASSIFICATION AND PARTNERSHIP TAX ISSUES 35–36 (Comm. Print 1997), *available at* https://www.jct.gov/publications.html?func=startdown&id=2071 (comparing the fair market value of property distributed to the pre-distribution fair market value of the distributee partner's partnership interest). In many instances, all of these methods arrive at the same result. *See infra* note 170 and accompanying text for an example of a distribution that would be treated as a partial

To illustrate how these definitions work, consider again the *ABC* partnership. Let's assume that the partnership is considering making a variety of distributions. Before it engages in any of these transactions, it has the following balance sheet:

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Cash	400	400	A	160	200
Inventory	10	100	B	160	200
Orangeacre	70	100	C	160	200
Total	480	600		480	600

Imagine that the partnership distributes $50 of cash to all three partners. This transaction would qualify as an operating distribution. Each partner would receive her respective share of the partnership's previously taxed income; the distribution has no other effect. Before and after the transaction, each partner holds an equal one-third interest in the partnership. Likewise, the amount and character of each partner's pre-distribution share of the partnership's built-in gains would be preserved. Indeed, the partnership would have the following balance sheet after the distribution:

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Cash	250	250	A	110	150
Inventory	10	100	B	110	150
Orangeacre	70	100	C	110	150
Total	330	450		330	450

liquidating distribution under all of these methods. Nonetheless, further study is required to determine whether one method would be superior to the others, or whether a standards-based approach that would allow partnerships to account for all relevant facts and circumstances would be preferable.

The tax treatment of the *ABC* partnership's distribution would remain largely unchanged under this proposal.[166] Neither the partnership nor the partners would recognize a gain on the distribution.[167] Each partner would instead reduce her outside basis to reflect the amount of cash distributed, from $160 to $110.[168]

The tax consequences would be the same if the partnership had made a series of cash distributions that, when taken together, were proportionate. More generally, if a partnership makes a series of individual distributions during the taxable year that, when aggregated, are proportionate, then the series of distributions would be treated as a single operating distribution.[169] For instance, imagine that the *ABC* partnership had staggered its $50 cash distributions, with *A* receiving her distribution in April, *B* in June, and *C* in November. Considered individually, these distributions may not qualify as operating distributions. But, together, they would be treated as a single operating distribution, effecting no change in the partners' interests in the partnership.

Alternatively, let's now assume that the *ABC* partnership does not distribute cash to its partners. Instead, it distributes Orangeacre to *C* in partial liquidation of her partnership interest. *C* relinquishes one-half of her partnership interest in the distribution, thus decreasing her interest in the enterprise from one-third to one-fifth and increasing *A*'s and *B*'s respective interests from one-third to two-fifths. This distribution would be treated as a liquidating distribution where *C* terminates a portion of her investment in the partnership.[170] Under this proposal, the tax consequences of this transaction—a

166. For a discussion of the proposed changes to the tax treatment of operating distributions, see *supra* notes 161–62 and accompanying text.

167. I.R.C. § 731(a)(1), (b) (2006).

168. *Id.* § 732(a)(1).

169. This aggregation rule would also apply to property distributions. In both instances, only the excess portion of any distribution would be treated as a liquidating distribution.

170. This distribution would be treated as a partial liquidating distribution under all of the method discussed *supra* note 165. Under the proportionate reduction method, *C*'s partnership interest would be reduced by one-half ((1−.2⁄.33) ⁄ (1−.2) = .5, where .33 equals *C*'s pre-distribution partnership interest and .2 equals *C*'s post-distribution partnership interest). Likewise, using the value-based method, *C*'s distribution would reduce her interest in the partnership. Before the distribution, the fair market value of her partnership interest was $200 (1/3 of the $600 fair market value of the partnership). When she receives a distribution of Orangeacre, with a fair market value of $100, the distribution would represent one-half of the overall fair market value of her partnership interest.

transaction in which *C*'s investment is terminated—would follow a recognition-based approach.

3. Taxing Liquidating Distributions

A recognition-based approach is grounded in the principle that liquidating distributions are, in substance, taxable exchanges between partners and partnerships. A partnership transfers cash or property to a partner, and the partner relinquishes all or a portion of her interest in the partnership in exchange. When viewed in this light, liquidating distributions are straightforward property dispositions, giving rise to recognized gain at the partner level.

The tax treatment of the distributee partner would follow a recognition rule, with the liquidating distribution triggering the recognition of any built-in gain reflected in her partnership interest. In order to determine the amount and character of such gain, this proposal adopts the full fragmentation method.[171] Under full fragmentation, the partnership entity would be disregarded, and the distributee partner would be treated as disposing of her interest in each individual item of partnership property in a fully taxable transaction.[172] This method is thus grounded in the aggregate theory of partnerships, where each partner is considered a direct co-owner of a portion of each item of partnership property.[173] Put another way,

171. *See* Postlewaite et al., *supra* note 11, at 604–06. Other scholars have proposed taxing partnership distributions, but these proposals rely on alternative methods of determining the tax consequences to the distributee partner. *See* Berger, *supra* note 11, at 109 (proposing that Congress follow the corporate approach and adopt provisions treating disproportionate distributions like stock redemptions); Gergen, *supra* note 11, at 213–20 (proposing an accounts-based approach to partnership distributions, where a partner would recognize gain on a distribution in excess of her share of the partnership's accumulated earnings or debt).

172. This approach is similar to subchapter K's current treatment of sales of partnership interests, which follows a partial fragmentation approach. I.R.C. §§ 741, 751(a). As a general matter, sales of partnership interests follow the entity theory of partnerships. The sale of a partnership interest is treated like a sale of stock in a corporation; the selling partner is treated as if she sold an interest in the partnership entity itself, and any gain recognized on the sale is treated as a capital gain. *Id.* § 741. Consistent with its historic concerns about character conversions, however, Congress subjected these sales to a "look-through" rule, which uses partial fragmentation to prevent the conversion of ordinary income into capital gains. *Id.* § 751(a). In general terms, the partial fragmentation method requires a partnership to first identify its hot assets. *Id.* § 751(c), (d). To the extent that any portion of the purchase price is attributable to the sale of the partner's share of these hot assets, the selling partner's recognized gain is treated as ordinary income rather than capital gain. *Id.* § 751(a). For a more detailed discussion of sales of partnership interests and the use of the partial fragmentation method, see generally MCKEE ET AL., *supra* note 10, ¶ 17; WILLIS & POSTLEWAITE, *supra* note 54, ¶ 12.02.

173. *See supra* notes 19–20 and accompanying text.

full fragmentation looks through the partnership and assesses the consequences of a liquidating distribution on a property-by-property basis. In doing so, full fragmentation would best implement subchapter K's equitable priorities—it would preserve the amount and character of each partner's share of the partnership's pre-distribution built-in gains.[174]

Operationally, full fragmentation would follow the same basic approach as was applied to the partnership's distribution of property.[175] It would treat the partnership as if it had entered into a hypothetical sale of all its property immediately before the distribution. To the extent that the partnership would have allocated any hypothetical gains to the distributee partner, the full fragmentation method would require her to recognize these gains as part of the liquidating distribution. Likewise, the character of these recognized gains would be determined based on the hypothetical sale. Because this is a fully taxable transaction, the distributee partner would take a basis in any distributed property equal to its fair market value.

As a final step in the exchange, the partnership would adjust the basis of its remaining property to reflect any gains recognized by the distributee partner. This would be necessary to ensure that the post-distribution built-in gain in the partnership's property, as reflected in the difference between value and basis, only includes the remaining partners' share of the partnership's pre-distribution built-in gain.[176] Put another way, increasing the partnership's basis by the amount of gain recognized by the distributee partner would ensure that the remaining partners are not subsequently taxed on the distributee partner's share of any pre-distribution built-in gain. This basis adjustment would thus serve a critical role in a recognition-based approach, preserving the amount and character of the non-distributee partners' respective shares of pre-distribution built-in gain.

There is, however, one practical wrinkle in applying the full fragmentation method to liquidating distributions, relating to the

174. *See infra* note 182 and accompanying text.

175. *See supra* Part III.A.1.

176. For capital account purposes, the treatment of the distributee partner should mirror the tax treatment. To the extent that distributee partner recognizes any economic gain on the exchange, the book value of the partnership's remaining property should be increased accordingly. In doing so, partnership rebookings would no longer be necessary in order to address the changes resulting from a liquidating distribution.

treatment of partial liquidating distributions. To that end, let's return to the *ABC* partnership's distribution of Orangeacre to *C* in partial liquidation of her partnership interest, which provides a useful illustration. Because the distribution of Orangeacre would not completely liquidate *C*'s partnership interest, she would remain a partner in the partnership following the transaction. It is thus necessary to split *C*'s partnership interest into two separate interests when applying the full fragmentation method; *C* would redeem one partnership interest in the partial liquidating distribution, and she would retain the other partnership interest.

As previously discussed, *C* relinquished one-half of her partnership interest in this distribution, reducing her interest from one-third to one-fifth.[177] The partnership would thus divide *C*'s interest accordingly, using the percentage change in her partnership interest to determine the value and basis of the liquidated and retained interests. As a result, *C* would be deemed to liquidate one-half of her partnership interest in the partial liquidating distribution. The full fragmentation method would treat *C* as if she held two partnership interests, each with a fair market value of $100 and a basis of $85.[178] And one of these interests would be redeemed in the liquidating distribution.

Applying the full fragmentation method, *C* would be treated as if she received Orangeacre and, in exchange, relinquished a portion of her interest in the partnership's remaining property—the cash and Inventory—in a fully taxable transaction. *C* would recognize a $15 ordinary gain on this exchange. The gain would be determined based on the partnership's hypothetical sale of the Inventory for its fair market value of $100 immediately before the distribution. The partnership would recognize a $90 ordinary gain on this fictional

177. *See supra* note 170 and accompanying text.

178. Immediately before the liquidating distribution, *C* held a single partnership interest with a fair market value of $200 and a basis of $170 ($160 original basis plus $10 share of gain recognized in connection with Orangeacre's distribution). This outside basis of $170 takes into account the partnership's recognition of gain on Orangeacre's distribution, which is discussed *supra* Part III.A.1. There is thus a $30 built-in gain in this single pre-distribution partnership interest, and such built-in gain is attributable to the Inventory. When the partnership interest is divided into two equal partnership interests—one to be liquidated and one to be retained—each partnership interest has a fair market value of $100 ($200 fair market value of single interest * ½) and an outside basis of $85 ($170 basis of single interest * ½). Accordingly, each of these partnership interests has a built-in gain of $15 ($100 fair market value of divided interest less $85 outside basis).

sale, and it would allocate the gain equally among the partners, $30 each.[179] *C*'s $30 share of this gain would then be divided between her two partnership interests based on their relative values. In this instance, the liquidated partnership interest and the retained partnership interest are of equal value; thus, a $15 ordinary gain would be allocated to *C*'s liquidated partnership interest. The partnership, in turn, would increase its basis in the Inventory by $15, from $10 to $25, to reflect *C*'s recognized gain. Likewise, *C* would take a basis of $100 in Orangeacre, reflecting its fair market value at the time of the exchange.[180]

After the liquidating distribution, the partnership would have the following balance sheet:

Assets	*Basis*	*Value*	*Capital*	*Basis*	*Value*
Cash	400	400	A	170	200
Inventory	25	100	B	170	200
			C	85	100
Total	425	500		425	500

C would now have a one-fifth interest in the partnership, and *A*'s and *B*'s respective interests would increase to two-fifths.[181] Going forward, the partnership would allocate all taxable items—including items attributable to the Inventory—using this post-distribution sharing ratio. Put another way, the *ABC* partnership would essentially become a new partnership, operating on a clean slate without any need to look back to its pre-distribution history.

179. The Inventory would be sold for $100, when its basis was $10; hence, the partnership would recognize a $90 ordinary gain on the hypothetical sale. I.R.C. § 1001 (2006).

180. This exchange would have no effect on *C*'s retained partnership interest. Her outside basis in the retained interest would thus remain $85.

181. Immediately after the liquidating distribution to *C*, the partnership would hold assets with an aggregate fair market value of $500. *C* would hold a partnership interest with a fair market value of $100; hence, she holds a one-fifth interest in the partnership. *A* and *B*, in contrast, would each hold partnership interests worth $200. Accordingly, their respective partnership interests reflect a two-fifths interest in the partnership.

Of equal importance, the full fragmentation method would preserve the amount and character of each partner's share of the Inventory's pre-distribution built-in gain. Before the distribution, there was $90 of built-in gain in the Inventory, and each partner's share of this gain was $30. The partial liquidating distribution to *C* would not alter these shares; each partner would either recognize her respective share, or such share would be preserved for future recognition on the partnership's sale of the Inventory.

Consider *A* and *B*, the non-distributee partners. If the partnership were to sell the Inventory following the distribution, it would recognize a $75 ordinary gain, reflecting the difference between the property's fair market value of $100 and its basis of $25. The partnership would allocate this gain among the partners based on their post-distribution sharing arrangement. *A* and *B* would thus each be allocated two-fifths, or $30, of this ordinary gain, consistent with their pre-distribution shares of the Inventory's built-in gain. The same would be true for *C*. She would be allocated one-fifth, or $15, of ordinary gain on the partnership's sale of the Inventory. When combined with the $15 of ordinary gain that she recognized on the distribution, the full fragmentation method would properly account for *C*'s $30 share of the Inventory's pre-distribution built-in gain.

B. A New Day for Partnership Distributions

A recognition-based approach to liquidating distributions would be transformative, modernizing and rationalizing subchapter K's treatment of these ubiquitous transactions. By recasting liquidating distributions as taxable exchanges between partnerships and their partners, this approach would align the tax treatment of liquidating distributions with their commercial reality.

A recognition-based approach would focus attention on the defining aspect of liquidating distributions—the severing of investment ties between partners and property. Liquidating distributions mark the end of an investment relationship, thus signaling that tax deferral is no longer appropriate.[182] Considered in

182. In arguing for a recognition-based approach to partnership distributions, one scholar described a distributee partner's decision to retain distributed property as a new investment decision, one warranting current taxation. Postlewaite et al., *supra* note 11, at 597–98. To Professor Postlewaite, a distributee partner has several options on receipt of a liquidating distribution: she can sell the distributed property for its fair market value; she can borrow against

this light, a recognition rule simply implements the foundational principle that a transaction's tax consequences should match its corresponding economic consequences.

Nonetheless, a recognition-based approach to distributions may initially seem like a radical realignment of subchapter K's distribution system. Yet the shift is largely expressive, reflecting the evolving role of recognition in partnership distributions. As previously discussed, nonrecognition in partnership distributions has never been absolute, and Congress has increasingly turned to recognition-based anti-abuse provisions in its efforts to combat abusive distributions.[183] The fight against tax shelters has already eroded Congress's commitment to nonrecognition in partnership distributions. Accordingly, a recognition-based approach is best viewed as the culmination of decades of governmental activity, not as a revolutionary break with the past.[184]

This approach, however, would mark a new day for partnership distributions. A recognition-based approach would bypass most, if not all, of the traditional challenges of partnership distributions. In doing so, it would raise promising possibilities, offering the hope of a simpler, more equitable, and more stable system of partnership distributions.

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such property; or, if she had preferred, the distributee partner could have requested that the partnership make her a distribution in cash, rather than property. *Id.* at 597. These options serve to highlight the partner's changing investment and, in turn, the propriety of a recognition-based approach. Indeed, Professor Postlewaite would treat the distributee partner as if she "had sold [her partnership] interest for cash and had subsequently purchased the assets, or had received cash and had thereafter purchased them." *Id.* at 598.

183. *See supra* Part II.C.2.

184. A recognition-based approach is also consistent with the larger trend toward entity treatment in the taxation of business enterprises. The 1986 repeal of the General Utilities doctrine had a profound impact on the treatment of corporate distributions and the taxation of business entities, more broadly. Tax Reform Act of 1986, PUB. L. NO. 99-514, § 631, 100 Stat. 2085, 2272 (codified at I.R.C. § 311(b)). Although a detailed discussion of the treatment of distributions under subchapters C and S is beyond this Article's scope, the provisions governing corporate distributions are grounded in a recognition premise. *See generally* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 8.21, 9, 10 (7th ed. 2000); JAMES S. EUSTICE & JOEL D. KUNTZ, FEDERAL INCOME TAXATION OF S CORPORATIONS ¶¶ 8, 13 (4th ed. 2001). There is no reason why this trend toward recognition should not extend into subchapter K. *See supra* note 156; *see, e.g.*, Lokken, *Future Without Subchapter K*, *supra* note 5, at 270 ("This [recognition] principle applies to S Corporations, as well as C Corporations, establishing a history of gain recognition on distributions by pass-through entities.").

Simplification would be the most immediate benefit of this approach to partnership distributions.[185] These reforms would streamline the number and complexity of subchapter K's distribution provisions. Because a recognition rule would prevent partnerships from using distributions as vehicles for tax sheltering, subchapter K would no longer require an arsenal of anti-abuse provisions.[186] Nor would it require the secondary provisions that currently support these anti-abuse provisions.[187] Congress could thus dismantle large swaths of subchapter K's complicated distribution system.

A recognition-based approach would also strip away much of subchapter K's operational technicality. As previously discussed, the distribution system's complexity is driven, in part, by rule design, with Congress trying to reconcile flexibility and equity through intricate and targeted provisions.[188] By sacrificing nonrecognition, and therefore flexibility, Congress would be able to recalibrate the design of these provisions, clearing a path toward a more accessible distribution system. Indeed, a recognition-based approach would track a widely understood model—the general tax treatment of property dispositions.[189] In doing so, partnerships would face a simpler, more rational distribution system.

Alongside simplification, a recognition-based approach would better serve subchapter K's equitable goals, preventing partnerships from using distributions as vehicles for character conversions, income shifting, and income avoidance. It would achieve this result by ensuring that a distribution does not affect the amount or character of any partner's share of the partnership's pre-distribution built-in gains. These amounts would either be recognized at the time of distribution or preserved for future recognition by the appropriate partner on a future sale of the partnership's property.

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185. *See* AM. LAW INST., MEMORANDUM NO. 3, *supra* note 11, at 78 ("Administratively, [recognition] would be the simplest option—no inside basis adjustments on a distribution, no allocation problems . . . no need for Section 751(b)"); Burke, *supra* note 7, at 699 (noting that a recognition-based approach "is simpler than existing section 751(b). It would ensure that the partners' post-distribution tax capital accounts and shares of [built-in gain] generally correspond to their continuing percentage interests, thereby simplifying partnership accounting.").

186. *See, e.g.*, I.R.C. §§ 704(c)(1)(B), 707(a)(2)(B), 731(a)(2), 734(b), 735, 737, 751(b) (2006); Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(ii).

187. *See, e.g.*, *supra* note 126.

188. *See supra* Part II.C.1.

189. Additionally, taxing partnership distributions of property would track the entity-level treatment of corporate distributions since the 1986 repeal of General Utilities. *See supra* note 155.

Likewise, these reforms would promote vertical equity norms. A recognition-based approach would ameliorate the burden borne by the many well-intentioned partnerships currently forced to navigate a discordant system designed for the small number of partnerships pursuing tax shelters. It would thus allow these everyday partnerships to focus on their primary objective—the commercial needs of their enterprise—instead of subchapter K's distribution system.

A recognition-based approach would also introduce much-needed stability into partnership distributions. Despite the prevalence of these distributions, their tax treatment remains surprisingly uncertain. A recognition-based approach would change this, creating a coherent system of taxation grounded in the premise that liquidating distributions are taxable property dispositions. Everything in this reconstituted system, from organizing principles to individual provisions, would derive from this one premise. A harmonious foundation, in turn, would allow partnerships to "see" how distributions work, hence improving their ability to apply the law and adapt it to novel distributions as they arise.

All together, a recognition-based approach would foster simplicity, equity, and stability in partnership distributions. Yet, the benefits of a reformed distribution system would extend beyond subchapter K. Most immediately, compliance would improve across the partnership spectrum. At one extreme, well-intentioned partnerships would be able to understand and apply these reformed provisions without the expenditure of excessive resources. At the other extreme, sheltering partnerships would find a recognition-based approach more costly and more difficult to manipulate. Indeed, it would deny these partnerships the two items that have proven instrumental in their pursuit of tax shelters: subchapter K's current technical, yet porous, provisions, and the shield created by the noncompliance of everyday partnerships.

Improved compliance, in turn, would increase government revenues and nurture a sense of public legitimacy in subchapter K. A new cycle would emerge in partnership distributions: a recognition-based approach would promote simplicity, equity, and stability in distributions; improved functionality would foster compliance and public legitimacy; and a growing sense of fairness would further reinforce the system's first principles of simplicity, equity, and stability. Eliminating nonrecognition would thus clear the path to a better and more harmonious system of partnership distributions.

C. Some Objections

Any proposal for reforming partnership distributions is likely to give rise to debate and criticism, and a recognition-based approach is no exception. This subpart addresses several possible objections to this proposal, concluding that none offers a compelling argument against subchapter K's reform. On the contrary, these potential objections provide a final opportunity to consider the desirability of a recognition-based approach to partnership distributions.

1. Recognition as Market Chilling

A critic might object to this proposal's rejection of nonrecognition, which is often considered a cornerstone of partnership taxation. To this critic, nonrecognition promotes the flexibility and informality that have historically defined subchapter K; thus, the shift to a recognition-based approach would fundamentally alter the nature of partnership distributions.[190] In doing so, a recognition rule might jeopardize the popularity of subchapter K and chill the market for partnership transactions.[191]

This potential objection is overstated. As previously discussed, recognition is not unknown in partnership distributions; subchapter K has always included recognition-based anti-abuse provisions.[192] Throughout subchapter K's history, Congress has increasingly turned to recognition rules to combat abusive distributions. Today, "many partnership distributions are *not* nonrecognition events."[193]

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190. *See, e.g.*, AM. LAW INST., MEMORANDUM NO. 3, *supra* note 11, at 78; Burke, *supra* note 11, at 680; Ernst & Young LLP, *supra* note 153; Rebecca S. Rudnick, *Enforcing the Fundamental Premises of Partnership Taxation*, 22 HOFSTRA L. REV. 229, 359 (1993).

191. *See, e.g.*, Burke, *supra* note 11, at 680; Ernst & Young LLP, *supra* note 153; Jackson et al., *1954 American Law Institute Draft*, *supra* note 64, at 154.

192. *See supra* Part II.C.2.

193. *See* Yin, *supra* note 5, at 226. In addition, there are likely large numbers of distributions that should be treated as recognition events under current law, but are erroneously treated as nonrecognition transactions by partnerships. In many of these instances, the culprit may be subchapter K's distribution system itself, with its complicated arsenal of anti-abuse provisions. Considered in this light, the increased number of partnership distributions that would be taxed under a recognition-based approach may be misleading. A portion of this "increase" would stem from improved compliance, rather than a foundational change in the law.

Even so, a recognition-based approach to distributions would accelerate the recognition of gain by some partners. Yet this would be appropriate. Nonrecognition is not justified in transactions where a partner's or a partnership's investment in property is terminated.[194]

Notwithstanding the cost of any accelerated gain recognition, there is little reason to believe that a recognition-based approach to distributions would chill the market for commercial partnership transactions.[195] As previously discussed, liquidating distributions are often driven by personal considerations or commercial imperatives.[196] Although tax planning may play an important role in structuring these transactions, it is a secondary role. Likewise, the administrative cost savings of a streamlined distribution system should offset some portion of the additional tax costs. This proposal's administrative savings would thus further diminish the potential deterrent effect of a recognition rule.

2. Recognition as Counterproductive

A critic might also argue that the shift to a recognition-based approach would be counterproductive from a complexity perspective,

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194. *See supra* Part II.D.1. Much of the scholarly debate regarding nonrecognition in subchapter K has taken place in the context of partnership contributions, rather than partnership distributions. *See, e.g.*, Burke, *supra* note 112, at 522–29; Laura E. Cunningham & Noël B. Cunningham, *Simplifying Subchapter K: The Deferred Sales Method*, 51 SMU L. REV. 1 (1997); Keyser, *supra* note 112; Andrea R. Monroe, *Saving Subchapter K: Substance, Shattered Ceilings, and the Problem of Contributed Property*, 74 BROOK. L. REV. 1381 (2009); John P. Steines, *Partnership Allocations of Built-In Gain or Loss*, 45 TAX LAW REV. 615, 653–55 (1990). Whatever one's view of the merits of nonrecognition in partnership contributions, it is important to consider partnership distributions separately. Indeed, the policy rationales supporting nonrecognition appear far less strong in the partnership distribution context. *See* Berger, *supra* note 11, at 154–55 ("[A]fter the business is under way, there is little purpose in continued nonrecognition when the venture disposes of business assets by returning them to the investors. And, if the distribution is pursuant to a liquidation, the case of nonrecognition virtually disappears as the conversion of an ongoing business from a partnership to a sole proprietorship rarely occurs."); Burke, *supra* note 112, at 534 ("Deferral of gain or loss inherent in the distributee's share of partnership assets should not be permitted for a non-pro rata distribution, since the distributee has effectively terminated his interest in a portion of the partnership's underlying assets and should be taxed accordingly."); Lokken, *supra* note 5, at 270 ("Requiring recognition on distribution is probably less disruptive of legitimate business operations than would be recognition on contribution."); Postlewaite et al., *supra* note 11, at 597–98; Yin, *supra* note 5, at 226.

195. A recognition-based approach may adversely affect the popularity of subchapter K with sheltering partnerships. That, however, should be considered a strength, not a weakness, of this proposal.

196. *See* Burke, *supra* note 11, at 727; Yin, *supra* note 5, at 226; *see also supra* notes 31–32 and accompanying text.

simply replacing one challenging system of taxing distributions with another. This critic might note that a recognition rule relies on mechanics—line drawing between distributions and full fragmentation—that have been considered and rejected in the past, in part, because of their complexity.[197] Accordingly, this approach might prove too complicated for modern partnerships, undermining its simplification goals.

In truth, complexity objections seem more nostalgic than substantive. No distribution system can eliminate complexity entirely; partnership distributions, particularly liquidating distributions, are too challenging. Yet a recognition-based approach is distinctive in its potential to streamline subchapter K. By eliminating nonrecognition in partnership distributions, this proposal addresses the problem instead of its symptoms, clearing a path to a simpler, more stable distribution system.

Nonetheless, this objection overstates the potential complexity of a recognition-based approach. In both theory and practice, this recognition-based approach focuses on commercial reality, proposing reforms that would conform the tax treatment of distributions to their economic substance.[198] Redefining distributions, for example, would reflect the fundamental commercial differences between operating distributions and liquidating distributions.[199] In

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197. *See, e.g.*, Burke, *supra* note 11, at 680; Jackson et al., *Internal Revenue Code of 1954*, *supra* note 64, at 1211.

198. A related objection to a recognition-based approach to distributions focuses on the administrative costs of a recognition rule, in particular the costs associated with valuing partnership interests and partnership property. However, it is likely that many partnerships already value their property in connection with distributions. *See, e.g.*, Gergen, *supra* note 11, at 210–11 ("[T]axing gains on asset distributions and redemptions of interests by partners imposes some new administrative duties, but the additional administrative burden should be small since most of the relevant information (for example, the value of a partner's capital account, the value of the distributed asset, and the value of other assets) already must be produced."); Postlewaite et al., *supra* note 11, at 598–99. If, for example, a partnership elects to rebook its property as part of a liquidating distribution, the rules governing the rebooking process require the partnership to revalue its property. Treas. Reg. § 1.704-1(b)(2)(iv)(f)(1). Likewise, as a commercial matter, a partnership may be required to value all of its property in order to determine the fair market value of a retiring partner's partnership interest. *See* Postlewaite et al., *supra* note 11, at 598–99.

199. Line drawing in partnership distributions focuses attention on the question of the proper tax treatment of partially liquidating distributions. This question has proven quite controversial among partnership tax scholars. *Compare* Andrews, *supra* note 7, at 43 (recommending a "bifurcation" approach to partial liquidating distributions, where the distributee partner is treated as holding two partnership interests—a liquidated partnership interest and a retained partnership interest), Karen C. Burke, *Taxing Hot Asset Shifts*, 8 FLA. TAX REV. 327, 355 (2007), Burke, *supra* note 153, at 171, *and* Postlewaite et al., *supra* note 11, at 598, *with* AM. LAW INST.,

doing so, it would free Congress to design a comprehensive distribution system that taxes liquidating distributions as what they are—taxable property dispositions. A streamlined distribution system, in turn, would better resonate with partnerships, allowing them to more easily navigate partnership distributions and their inevitable challenges.

Likewise, taxing distributions is not a novel concept. Partnerships have considerable experience with recognition rules in the distribution context.[200] Partnerships also have experience with fragmentation; the rules governing the tax treatment of sales of partnership interests rely on a partial fragmentation method.[201] More generally, however, recognition is the baseline for property transactions throughout the federal income tax. Partnerships may thus rely on their most basic knowledge of general tax principles in navigating a reformed recognition-based distribution system.

3. Recognition as Futile

A third potential objection to a recognition-based approach focuses on the futility of reforming partnership distributions. This critic would assert that a recognition rule would not prevent tax abuse. If distributions no longer provided tax-advantaged results, then wealthy and well-advised partnerships would simply find alternative means of deferring tax.[202]

This objection proves too much, calling into question any recognition-based effort to combat abusive distributions, including

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MEMORANDUM NO. 3, *supra* note 11, at 55–58, Jackson et al., *Internal Revenue Code of 1954*, *supra* note 64, at 145–46 (explaining that special rules for partial liquidating distributions are difficult and rarely needed), Massey, *supra* note 153 (describing a speech given by William McKee in which a partial liquidation rule was described as a "stealth bomber proposal" that "radically changed the theory of subchapter K"), *and* Yin, *supra* note 5, at 229.

200. *See supra* Part II.C.2.

201. I.R.C. §§ 741, 751(a) (2006). For a more detailed discussion of the partial fragmentation approach that applies to sales of partnership interests, see *supra* note 172. Additionally, section 1411 adopts a fragmentation approach when determining a taxpayers' net investment income subject to tax. I.R.C. § 1411(c)(4). For purposes of this provision, net investment income includes any net gain attributable to the disposition of an active interest in a partnership. *Id.* § 1411(c)(1)(A)(iii). In order to compute this amount, the partnership is deemed to sell all of its assets for their fair market value immediately before the disposition of the taxpayer's partnership interest. *Id.* § 1411(c)(4)(A). Any gains allocated to the partner on this hypothetical sale must be included in the computation of her net investment income. *Id.*

202. *See* AM. LAW INST., FEDERAL INCOME TAX PROJECT—TAXATION OF PASS-THROUGH ENTITIES: MEMORANDUM NO. 2, 72–73 (1996); Burke, *supra* note 11, at 727–28.

the current law's array of anti-abuse rules.[203] At the same time, it ignores all of the abusive distributions that a recognition-based approach would eliminate. Even so, I do not mean to suggest that concern about disguised distributions is without merit; the ease with which a partnership might achieve comparable results through an alternative transaction is an important consideration in rethinking subchapter K's distribution system. But it is neither a new concern, nor a concern unique to partnership taxation. Disguised transactions are a universal problem in the federal income tax and, hence, solutions relying on general tax principles might prove promising in addressing abusive distributions.[204] It is indeed hard to imagine that the application of general tax principles would produce worse results than subchapter K's current system of taxing partnership distributions.

IV. Conclusion

This Article offers an alternative vision of partnership distributions, drawing its inspiration from an unexpected source—the inimitable section 751(b) disproportionate distribution rule. Partnership distributions are deeply flawed, and the time has come to rethink everything about these ubiquitous transactions, beginning with the nonrecognition premise at the system's foundation. This Article thus reimagines partnership distributions liberated from nonrecognition, proposing a system grounded in commercial reality, where liquidating distributions would be treated as taxable exchanges between the partnership and the distributee partner.

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203. As one partnership tax scholar presciently noted: "It may seem somewhat opportunistic to defend the permissiveness of the distribution rules on the ground that stricter rules would be self-defeating due to their easy avoidability. Indeed, dissatisfaction with the flexibility of partnership allocations generally, as well as with the perceived shortcomings of the disguised sale rules, may fuel more radical proposals to curb the permissiveness of the distribution rules." Burke, *supra* note 11, at 728.

204. Indeed, sharing responsibility for abusive distributions with provisions outside subchapter K would serve an expressive function, reflecting the reality of modern partnerships. The activities of partnerships that pursue tax shelters are unpredictable, and their transactions are increasingly individualized. Even worse, the current law has proven problematic for the large number of partnerships that are not engaged in tax shelters themselves, but are nonetheless forced to bear the complexity of subchapter K's formidable distribution system. In the increasingly polarized world of partnership taxation, it may simply no longer be possible (if it ever was) to design functional provisions that prevent the abusive distributions of sheltering partnerships and simultaneously promote the legitimate commercial interests of non-sheltering partnerships.

With recognition guiding our thinking about partnership distributions, transformative changes would become possible. Aligning the tax treatment of distributions with their economic substance would streamline the system, reducing the number and complexity of subchapter K's distribution provisions. At the same time, a recognition rule would prevent abuse by cutting off deferral at the time of distribution. Reduced complexity and abuse, in turn, would lead to greater stability in partnership distributions, with partnerships able to see the system applying equally to all partnerships, regardless of their income or sophistication levels. Taken together, a recognition-based approach would thus improve the functionality of partnership distributions, taking important steps toward simplicity, equity, and stability in subchapter K.

Reforming partnership distributions offers a unique lens through which to consider the larger project of rethinking partnership taxation. Distributions are distinctively situated in subchapter K, standing at the intersection of its many provisions, abuses, and dysfunctions. Distributions are thus the perfect incubator for thinking deeply about partnership taxation and its future. Indeed, solving the problem of partnership distributions may clear a path to more comprehensive reforms in this important, but under-theorized, area of the federal income tax.